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GENERAL
UNCERTAIN TAX POSITIONS – IFRIC 23

TAX ADMINISTRATION
OECD PILLAR TWO – GLOBAL MINIMUM TAX

VALUE-ADDED TAX
REFINED SECOND-HAND GOLD

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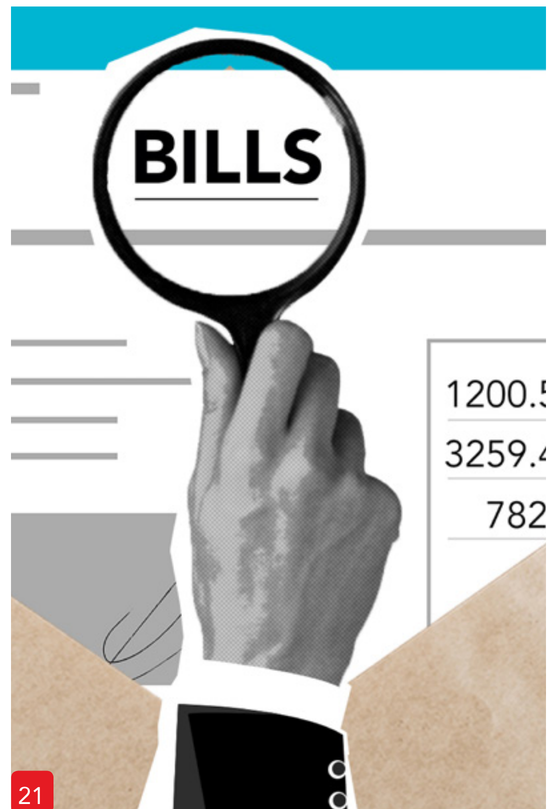

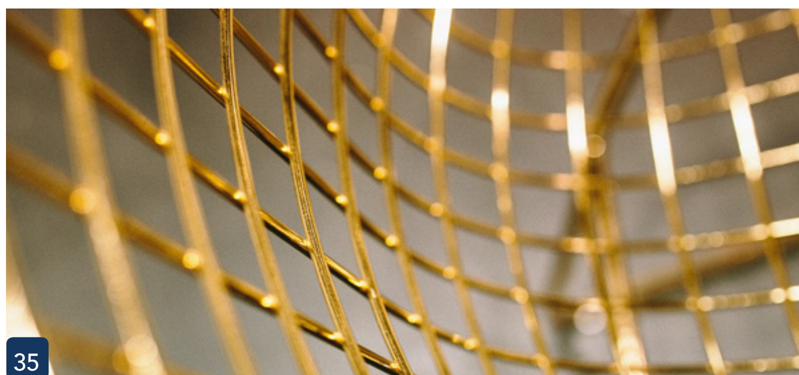

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MONEYLENDING – *TAXPAYER H V CSARS* (SARSTC 14213)

In this appeal, Taxpayer H challenged SARS' decision in allowing a partial deduction of the interest expense it had sought to deduct during the 2011 year of assessment. Taxpayer H contended that the interest was fully deductible, as it was incurred in the course of carrying out its moneylending trade, and in the production of income.

FACTS

Taxpayer H is a private company that is an investment holding company with assets comprising of unlisted shares in subsidiary entities, loans advanced to the subsidiaries, and cash. Taxpayer H claimed that it conducted a moneylending trade with the specific purpose of making a profit from on-lending borrowed funds to its subsidiaries. Taxpayer H submitted that all money borrowed free of interest was used for share-investing activities, while interest-bearing borrowings were applied towards lending to the subsidiaries. However, the interest rates imposed by Taxpayer H ranged from 0% to 8.29%, while it borrowed at an interest rate of 8.29%. The South African Revenue Service (SARS), argued that the interest rates imposed by Taxpayer H had no commercial sagacity, and exposed the appellant's transactions as nothing more than furthering the group's interest by enhancing the earning capacity of the subsidiaries. Taxpayer H contended that it in fact did have a profit motive, which was already achieved in the 2012 year of assessment. However, it seems that Taxpayer H included the interest it earned from financial institutions, ie, the bank, and did not only take into account the interest earned from the subsidiaries when it put forth the argument that it is in fact making a profit. When SARS raised the additional assessment, SARS limited the interest deduction, to the interest earned, based on the long-standing practice as set out in SARS Practice Note 31 (PN 31: "Income Tax: Interest paid on moneys borrowed"). SARS also imposed an understatement penalty as provided for in section 223 of the Tax Administration Act, 2011 (the TAA)

"SARS also pointed out that on the IT14 submitted by Taxpayer H for the 2011 year of assessment, it answered 'NO' where it was asked whether or not it entered into any transaction contemplated in section 24J of the Income Tax Act, 1962 (the Act)."

ISSUES

Issue 1: Whether the interest sought to be deducted by Taxpayer H was incurred whilst carrying on a trade;

Issue 2: Whether the interest sought to be deducted by Taxpayer H was incurred in the production of income; and

Issue 3: Whether SARS has successfully discharged the onus resting on it for its imposition of the understatement penalty

FINDINGS

In order to decide on issue 1, the court relied on the guidelines established in *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue,* [1991], in order to determine whether Taxpayer H was carrying on a trade as a moneylender or banker. According to *Solaglass,* lending had to be done on a system or plan which disclosed a degree of continuity in laying out and getting back the capital for further use and which involved a frequent turnover of the capital; even though obtaining security was a usual feature, though not essential, of a loan made in the course of a moneylending business; the fact that money had been lent at remunerative rates of interest was not enough to show that the business was one of moneylending; and as to the proportion of the income from loans to the total income: the smallness of the proportion could, however, not be decisive if the other essential elements of a moneylending business existed.

When Taxpayer H was requested to provide proof as to the existence of its moneylending business, it indicated that the loans had no terms, including repayment terms. Taxpayer H could not provide board minutes, or documents evidencing its lending policy, or that security was provided for the loans. Taxpayer H also could not provide evidence of a plan of laying out and getting in its money to prove continuity. SARS also pointed out that on the IT14 submitted by Taxpayer H for the 2011 year of assessment, it answered "NO" where it was asked whether or not it entered into any transaction contemplated in section 24J of the Income Tax Act, 1962 (the Act). This became important since Taxpayer H underscored the words "all accrual amounts" in section 24J(3) of the Act, in order to include the interest accruals from the bank to show a profit. SARS maintained that there cannot be a profit-making motive if Taxpayer H's interest expense will be more than its interest income, as a result of Taxpayer H's own lending policies. In this regard, SARS was able to provide proof that the interest earned from the bank came from the cash-pooling activities of the group. This claim was not denied by Taxpayer H. Accordingly, the interest expense could not have been linked to the interest income earned from the bank.

"Taxpayer H contended that the interest was fully deductible, as it was incurred in the course of carrying out its moneylending trade, and in the production of income."

Regarding issue 2, in order to determine whether the expenditure was incurred in the production of income, the important and sometimes overriding factor is the purpose for which the expenditure was incurred and what it actually effected. Taxpayer H argued that the expense was incurred in the production of interest, ie, the interest earned from its subsidiaries, and the fact that the interest expenses were more than the interest income, did not mean that the interest expense was not incurred in the production of income. According to Taxpayer H, the requirement of section 24J(2) of the Act was met. SARS argued that there was no intention to generate income and that the purpose of this lending arrangement was to further the group's interest. The court agreed with SARS since the taxpayer failed to demonstrate that the interest expense was incurred in the production of income.

When arguments were heard concerning issue 3, Taxpayer H affirmed its position that there was no understatement. In its view, the interest was fully deductible, and in the event that SARS is of the view that the interest is not deductible, it should be seen as a *bona fide* inadvertent error. Here Taxpayer H placed reliance on section 222(1) of the TAA, which stated that if the understatement resulted from a *bona fide* inadvertent error, no understatement penalty should be levied. Taxpayer H argued that it was for SARS to satisfy itself that the understatement did not result in such an error and that this is a jurisdictional fact for SARS to overcome prior to imposing any understatement penalty. The court did not agree with this argument by Taxpayer H. The court reminded Taxpayer H that the burden of proof set out in section 102(2) of the TAA cannot be turned on its head, and that the burden still lies with the taxpayer to prove that the interest expense was deductible and that it was up to the taxpayer to provide proof that the understatement was due to a *bona fide* inadvertent error. In this case, Taxpayer H did not provide such evidence, and its contention that it relied on expert advice could not be supported.

The appeal was dismissed with costs.

Franscios Celliers

Mazars

Acts and Bills

- Income Tax Act 58 of 1962: Section 24J;
- Tax Administration Act 28 of 2011: Sections 102(2), 222 & 223.

Other documents

- SARS Practice Note 31 ("Income Tax: Interest paid on moneys borrowed").
- IT14.

Cases

- *Taxpayer H v Commissioner for the South African Revenue Service* (IT 14213) (handed down on 9 February 2022);
- *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue* [1991] (2) SA 257 (A); [1991] 1 All SA 39 (A).

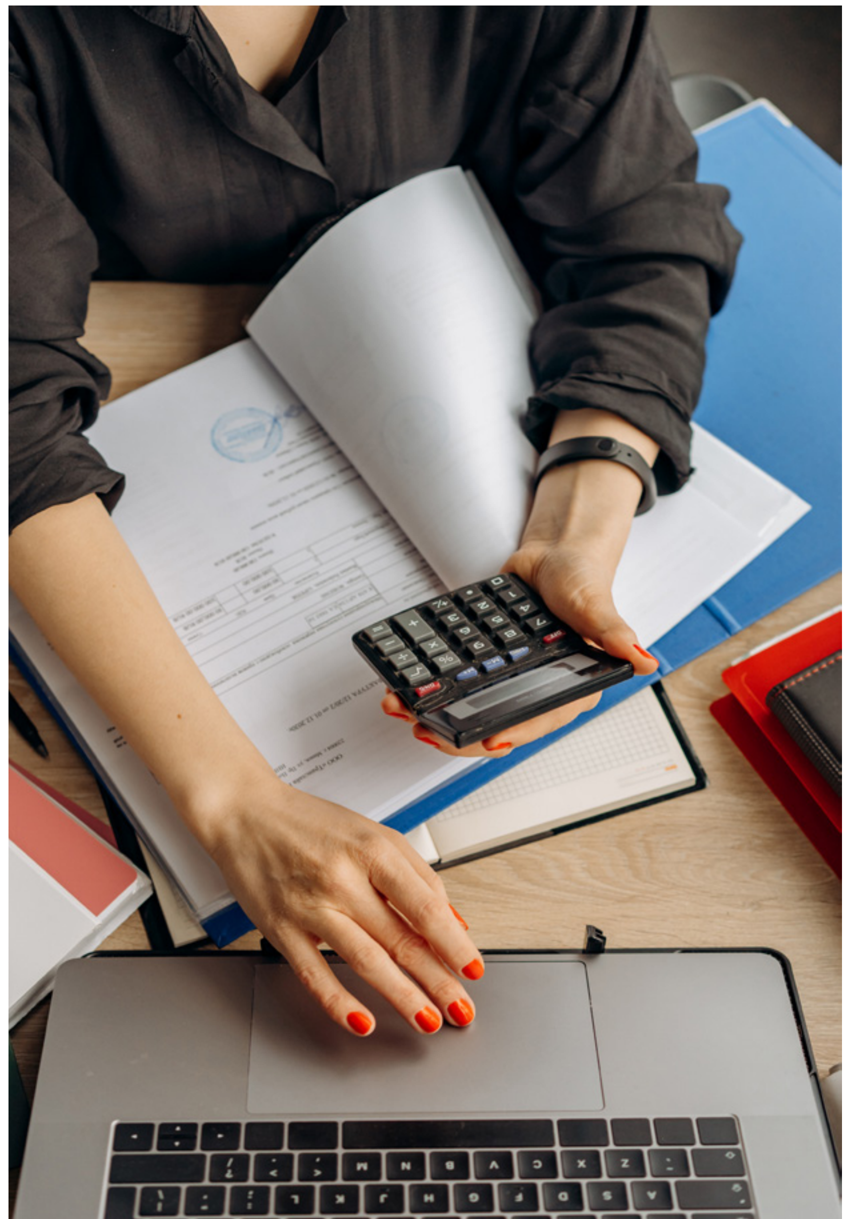
Tags: investment holding company; interest-bearing borrowings; understatement penalty; *bona fide* inadvertent error.

UNCERTAIN TAX POSITIONS – IFRIC 23

For financial year-end purposes, taxpayers consider the tax provisions as part of the company's financial position and how this will be disclosed in its annual financial statements (AFS). In this regard, the importance of tax certainty cannot be overstated.

The introduction of a minimum tax, the establishment of the automatic exchange of information, and the increased emphasis on tax transparency and disclosure obligations have created an environment where a wealth of ax information is freely available in the public domain. The increased focus by the South African Revenue Service (SARS) to increase revenue collection has amplified the pressure on statutory auditors to ensure that they accurately conclude the correct tax position and, where appropriate, ensure that the appropriate corresponding provisions are raised. These factors, exacerbated by the fast-changing tax environment, may cause auditors to adopt a more conservative view when reporting, as well as raise issues on principles that were previously accepted. It is imperative, therefore, that taxpayers are secure in their tax position.

It is within this context that IFRIC 23 becomes an important consideration. IFRIC 23 was developed by the International Financial Reporting Standards (IFRS) Interpretations Committee and issued by the International Accounting Standards Board to guide entities on how to reflect the effects of uncertainty as regards tax treatment in an entity's AFS. This applies to any tax type, and detection risk is not considered in the recognition and measurement of uncertain tax treatments. The entity should determine the probability that a tax authority will accept an uncertain tax treatment, and, to the extent that acceptance is considered probable, the entity should complete its AFS consistently with the tax treatment used. If, however, it is not probable that a tax authority will accept such a tax treatment, the entity should reflect the effect of the uncertainty in its AFS using specific methods as per the guidance contained in IFRIC 23 – this includes both the "most likely amount" and the "expected value" methods.



"IFRIC 23 was developed by the International Financial Reporting Standards (IFRS) Interpretations Committee and issued by the International Accounting Standards Board to guide entities on how to reflect the effects of uncertainty as regards tax treatment in an entity's AFS."

Since tax legislation, case law and SARS practice do not always provide absolute certainty on all transactions, uncertainty exists as to the tax treatment of certain positions that are open to interpretation. IFRIC 23, therefore, requires an entity to record a liability where it is considered probable that an uncertain tax treatment would not be resolved in favour of the taxpayer if reviewed by a tax authority (SARS).

Hence, the question arises whether a company should raise a liability, and the quantum of that liability, in terms of IFRIC 23 when for example, its auditor disagrees with a position taken; or its tax advisor points out that an alternative interpretation will likely be followed by SARS. The impact of raising a liability in terms of IFRIC 23 is that a theoretical tax risk will ultimately result in decreased net earnings for the company being reflected in its AFS, which could harm investor interest or the company's share price. Companies could also be required to disclose the uncertain tax position and provision raised in their transparency report, which could attract queries from SARS.

Companies should consider taking legal advice on uncertain tax positions in advance of the audit to obtain an independent opinion that confirms whether or not the tax position taken is correct and analyses the risk based on current law and interpretation. This will assist the company in having a motivated response to the auditor that an IFRIC 23 liability should not be raised.

It is important, therefore, that a taxpayer is secure in its tax position and is equipped with the tools necessary to defend such a position. To this end, taxpayers with uncertain tax positions should obtain legal advice from an appropriate tax practitioner.

Charles de Wet & Kristel van Rensburg

ENSafrica

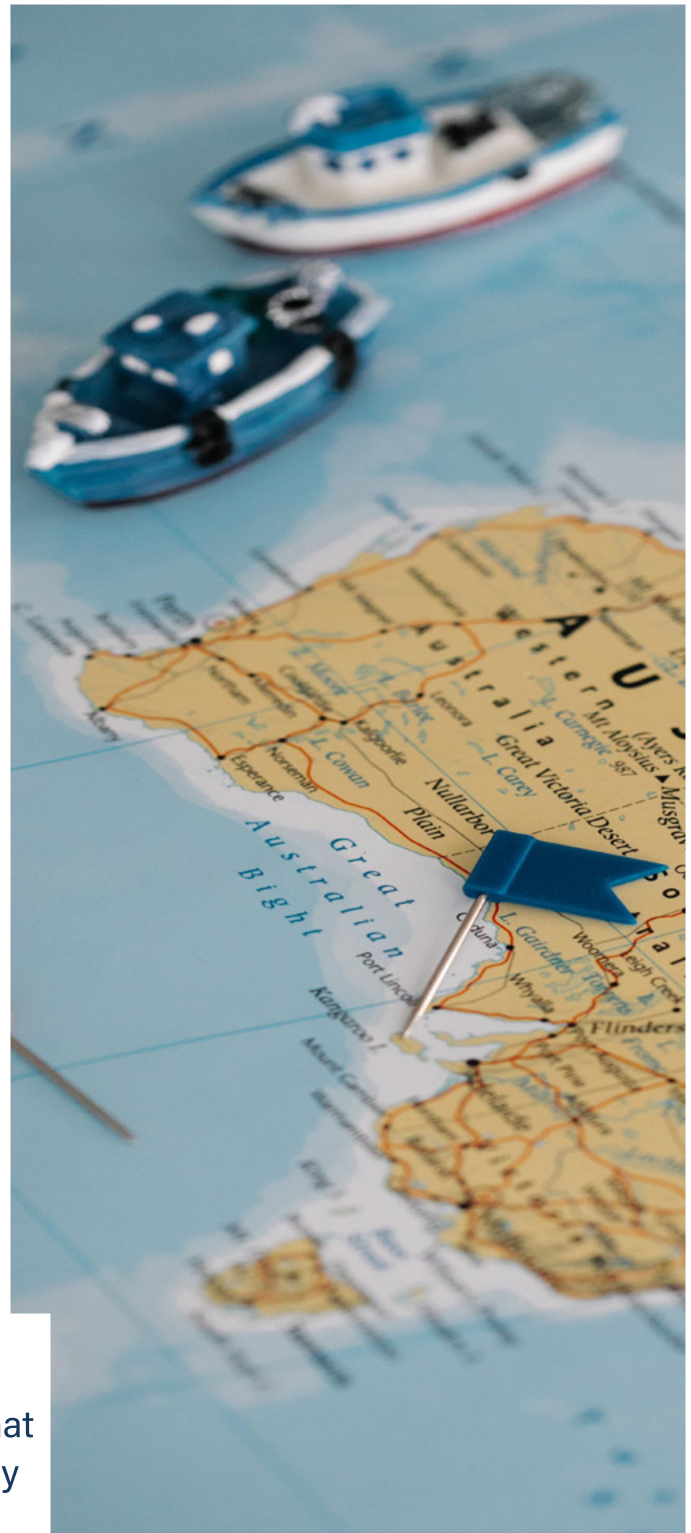
Other documents

- IFRIC 23 (developed by the International Financial Reporting Standards (IFRS) Interpretations Committee and issued by the International Accounting Standards Board to guide entities on how to reflect the effects of uncertainty as regards tax treatment in an entity's annual financial statements).

Tags: automatic exchange of information; uncertain tax treatments.

CFCs AND THE FOREIGN BUSINESS ESTABLISHMENT EXEMPTION

South Africans have created offshore companies for various reasons. A fairly common reason is simply to diversify risk, in that the South African person will then have some assets offshore. This seems to be an increasingly common trend.



Such offshore entities would usually be controlled foreign companies (CFCs) for tax purposes. An important issue that South African shareholders should be aware of is that the income of such CFC can be taxed in their hands in South Africa even if no income or dividend is repatriated to South Africa. This is in terms of our CFC rules.

There are two broad categories within our CFC rules which prevent the attribution of income from a CFC to a South African resident.

The first is the so-called high tax exemption. The hypothetical question is asked whether, if the CFC had been a South African tax resident, its theoretical South African income tax payable would have been at least 67.5% of the actual foreign income tax payable.

The second is an exemption for income that is attributable to a foreign business establishment (FBE) in the foreign country. There are some peculiarities and exceptions to this rule, but in essence the question in simple terms is whether the CFC has sufficient "substance" in the foreign county.

The requirements of the FBE exclusion are set out in section 9D of the Income Tax Act, 1962. In 2021, and for the first time in South Africa, the issue of whether a company had an FBE went to court and was the subject of the judgment in *ABCDE SA (Pty) Ltd v Commissioner for the South African Revenue Service* (IT 24596).

"A company may be incorporated outside of South Africa for many reasons that are unrelated to tax. The court was satisfied that AB had been incorporated in Ireland mainly for non-tax reasons."

We agree with the observation of the judge in this case that the CFC rules are lengthy, with multiple subsections, and that they have been subject to numerous amendments over the years.

In terms of the case, SARS was of the view that ABCDE's CFC (AB) did not have an FBE, and hence that ABCDE should, in terms of section 9D, include the income of AB in its income for South African tax purposes.

The judge had to consider whether the five requirements of the definition of FBE were applicable.

These five requirements can be summarised as whether the CFC has a fixed place of business located outside South Africa that is used or will be used for the carrying on of the business of that CFC for a period of not less than a year, where –

"An issue that was not so simple in this case was what the primary operations of AB were and, furthermore, whether such primary operations were conducted in Ireland at AB's offices."

- that business is conducted through a physical structure (offices, shops, factories, warehouses or other structures);
- that fixed place of business is suitably staffed with on-site employees who conduct the primary operations of that business;
- that fixed place of business is suitably equipped to conduct the primary operations of that business;
- that fixed place of business has suitable facilities to conduct the primary operations of that business; and
- that fixed place of business is located outside of South Africa solely or mainly for non-tax purposes.

All the above requirements must be met.

An issue that was not so simple in this case was what the primary operations of AB were and, furthermore, whether such primary operations were conducted in Ireland at AB's offices.

Briefly, AB was a financial company. Clients gave AB funds, and AB used these funds to generate income for its clients. AB earned a fee based on the funds provided. For AB to make a return to pay to its clients, it invested the funds.

AB ensured that it maintained its financial licence, made policy decisions and oversaw its operations. Four employees undertook this function in Ireland at the company's offices there. These employees were the managing director, two accountants and a compliance officer.

An obvious question is who managed the investment of the funds? This was outsourced to another company in the UK.

SARS was of the view that the management of the company was not the primary operation of AB, but the actual investment management was, and as this was outsourced, there was no FBE of the company as defined. SARS held the view that of the five requirements, the last four were not met.

The court held that investment management concerns the professional use of the clients' (investors') funds and falls under investment management trading activities. This is the day-to-day use of the money and plays a relatively minor role in the overall picture of fund management. The court also stated that fund management and not investment management was the core activity of AB, which includes maintaining its financial licence. Therefore, AB had an FBE as it is a fund management company and not an investment management company.

While we can see the distinction, one can understand where SARS was coming from – without anyone managing the investment of the funds, no-one would provide funds to AB.

We briefly mention that in terms of the last (anti-avoidance) requirement in the definition of FBE, various non-tax reasons were provided for incorporating AB in Ireland. A company may be incorporated outside of South Africa for many reasons that are unrelated to tax. The court was satisfied that AB had been incorporated in Ireland mainly for non-tax reasons.

It is unclear whether or not SARS is taking the above decision on appeal.

SO WHERE DOES THAT LEAVE YOU AND YOUR CFC?

Firstly, a question is asked in the annual income tax return, whether the taxpayer is a shareholder in a CFC. Then there is a further question of whether you have submitted an IT10B with your income tax return.

On the IT10B you can claim the FBE exemption as described above.

The above case was unusual in that it would not normally be a point of contention what the primary operations of a company are. Before claiming the FBE exemption, one should check whether or not the exemption applies with reference to all five requirements. It should also be noted that, regardless of whether or not income is actually attributable to an FBE, there are various situations in which income is still deemed to be taxable in the South African shareholders' hands, despite the existence of an FBE.

In summary, the CFC rules are complex. However, in our view, if correctly established for commercial reasons, CFCs can be used very effectively to house your off-shore business.

"There are two broad categories within our CFC rules which prevent the attribution of income from a CFC to a South African resident."

Hylton Cameron

BDO

Acts and Bills

- Income Tax Act 58 of 1962: Section 9D.

Other documents

- IT10B (Income Tax – Controlled Foreign Company (CFC) – 2012 onwards).

Cases

- *ABCDE SA (Pty) Ltd v Commissioner for the South African Revenue Service* (IT 24596) (17 September 2021).

Tags: controlled foreign companies (CFCs); foreign business establishment (FBE); fixed place of business; FBE exemption.

COVID TRAVEL RESTRICTIONS AND CORPORATE TAX RESIDENCY ISSUES

The days of the COVID-19 pandemic restrictions applying to foreign travel almost seem to be part of a bad memory. However, such travel restrictions may have had corporate tax consequences. Travel restrictions basically became effective around March 2020.

If we assume a 30 June year end of a foreign company that had several directors stuck in South Africa due to travel restrictions that arose due to the COVID-19 pandemic, from July 2020 to June 2021, this may arguably have resulted in the company becoming tax resident in South Africa for its 2021 year of assessment. Potentially, the company's 2021 tax return should already have been submitted.

Unfortunately, the restrictions and difficulty in travelling overseas continued for at least a year and a half, raising the risk for various onshore and offshore companies for this period.

"Often when an employee works in another country for a significant period (usually more than six months) they create a presence for their company in such other country."

Let us start at the beginning, and not where or when did the COVID-19 pandemic begin but rather when, in terms of South African tax law, does a company becomes a South African tax resident?

A company is a South African tax resident if its place of incorporation or place of effective management (POEM) is in South Africa. However, a company is deemed not to be tax resident in South Africa if it is exclusively resident of another country in terms of a double tax treaty between South Africa and the other country.

Generally, most of South African tax treaties provide that if the company is dual resident, ie, resident in a foreign country in terms of the foreign country's domestic provisions and resident in South Africa in terms of South Africa's domestic provisions, then in terms of the so-called "tie-breaker" treaty provisions, the company will ultimately be deemed to be resident where its POEM is.

THE QUESTION IS THEN – WHAT IS POEM?

In the 2014 OECD Commentary on the Model Tax Convention the following definition was provided:

> "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management."

The tie-breaker clause discussed above was removed from the OECD 2017 Model Tax Treaty. The new tie-breaker clause essentially states that in the case of a dual residency scenario, the two states must agree where the company is resident and that in arriving at such decision, have regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

During the past two years, due to the COVID-19 pandemic, many board meetings for offshore companies were simply held in South Africa or over a technology platform. The obvious reason was that the directors could not travel abroad due to the COVID-19 pandemic restrictions: in any event, it was difficult to comply with the various requirements in order to travel abroad. Somewhat more disturbing (for tax reasons), due to the past two years of travel restrictions, people have found that it is actually very easy to simply use technology and have the board meeting from the comfort of one's home.

Furthermore, even after the restrictions were lifted, it is still much easier to have a board meeting from one's home, or an office down the road.

However, the problem with this is that if the board members are making their decisions from their homes in South Africa, or if the important decisions are effectively being made from South Africa, the company may arguably be a South African tax resident.

The situation could also apply in the reverse scenario. If board members were stuck in a foreign country, the POEM of the company may have shifted to the foreign country.

In addition to the above, while not as extreme as changing a company's tax residency, employees who were stuck in a country may have generated income that is sourced in that country and, if a DTA is applicable, created a taxable presence for their employer in that country that means that that income may be taxable there.

Due to the travel restrictions, people may have been forced to remain in a particular country for longer than expected. While they were in such country, they would have continued working for their employer.

Often when an employee works in another country for a significant period (usually more than six months) they create a presence for their company in such other country. Technically speaking this presence is called a permanent establishment (PE). What this usually means is that the company has to register for tax in that country and potentially pay income tax and other taxes such as employees' tax there.

Even if no additional tax ultimately has to be paid in the foreign country, at the very least there may be an administrative burden and associated costs of registering for tax and submitting tax documents to the foreign tax authorities.

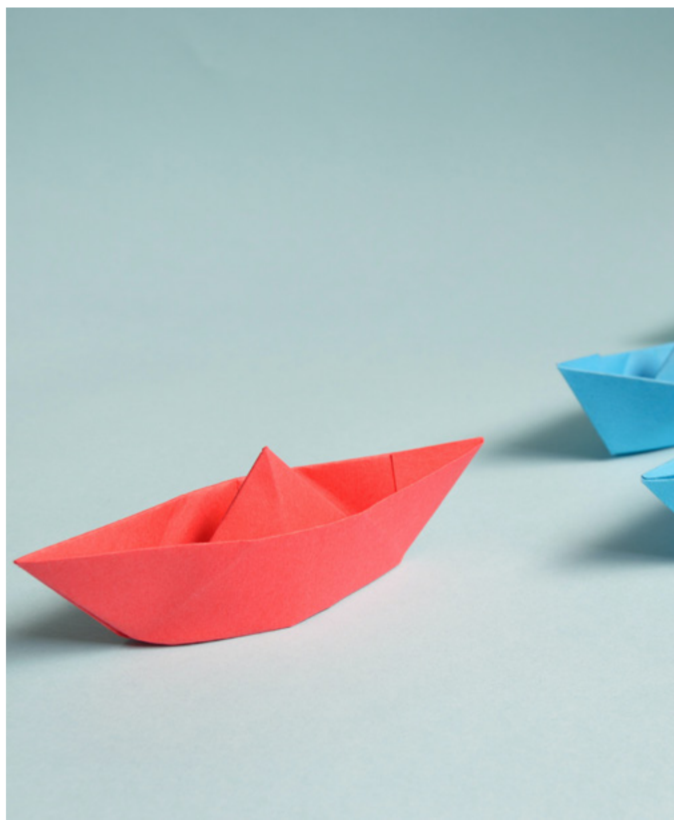
This issue was recognised by the OECD, and it issued a statement in this regard on 3 April 2020 and another on 21 January 2021 – both statements provided similar comments.

In essence the OECD expressed the view that changes of residency and the creation of a permanent establishment should not follow purely from the COVID-19 pandemic forcing persons to remain in a country.

In our view there are some good reasons to follow the OECD approach, but one needs to understand all the facts, and of course the risks.

A final issue, not mentioned by the OECD, revolves around South African offshore companies which are mainly owned or controlled by South African tax residents – controlled foreign companies. Without going into much detail, often an important issue for the controlled foreign company is whether it had an offshore office, and whether its employees used that office. During the COVID-19 pandemic numerous countries forced employees to work from home and/or ceased having an office. In other words, no employees were working at the office, if there was an office!

"The new tie-breaker clause essentially states that in the case of a dual residency scenario, the two states must agree where the company is resident and that in arriving at such decision, have regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors."



WHAT IS SARS' VIEW?

SARS sets out its view on what POEM means in Interpretation Note 6 (November 2015).

SARS was obviously fully aware of the COVID-19 pandemic and its effects and provided some amendments to the Income Tax Act, 1962, in this regard. These amendments mainly dealt with the taxation of individuals who were physically outside of South Africa while rendering services to an employer. SARS has, to date, not provided any views on the potential corporate issues raised above. It remains to be seen whether SARS will apply the views of the OECD discussed above.

Companies should ascertain if the location of their directors and employees has created any risks relating to the above issues, especially since tax returns for the above periods have been or are about to be submitted. Companies should check for what reasons their employees were physically offshore and document these reasons and whether they were forced to be there. Conversely, if employees were in South Africa, the reverse risks should be addressed and reasons documented.

A final word of caution: let us assume that the COVID-19 pandemic did prevent travelling – this restriction should no longer be applicable, so ensure that care is taken with regard to where the company's decision-making occurs and where work is performed!

"If we assume a 30 June year end of a foreign company that had several directors stuck in South Africa due to travel restrictions that arose due to the COVID-19 pandemic, from July 2020 to June 2021, this may arguably have resulted in the company becoming tax resident in South Africa for its 2021 year of assessment."

Hylton Cameron

BDO

Acts and Bills

- Income Tax Act 58 of 1962.

Other documents

- 2014 OECD Commentary on the Model Tax Convention (definition of "place of effective management" (POEM));
- OECD 2017 Model Tax Treaty;
- Statement issued by the OECD on 3 April 2020;
- Statement issued by the OECD on 21 January 2021;
- Interpretation Note 6 (Issue 2: "Resident – place of effective management (companies)" – 3 November 2015).

Tags: place of incorporation; place of effective management (POEM); "tie-breaker" treaty provisions; South African tax resident; controlled foreign companies.

RATIFICATION OF THE MLI

South Africa signed the Base Erosion and Profit Shifting (BEPS) Multilateral Instrument (MLI) on 17 June 2017, but since then very little progress has been made for it to be ratified, which is a prerequisite for it to be applicable to South Africa and the double tax agreements (DTAs) it has concluded with other countries.

However, on 25 May 2022, National Treasury and the South African Revenue Service (SARS) appeared before the National Assembly's Standing Committee on Finance (the SCOF) regarding South Africa's ratification of the MLI. In this article, we briefly discuss some of the issues discussed during the appearance of National Treasury and SARS before the SCOF and where things now stand.

WHAT IS THE MLI?

In their appearance before the SCOF, National Treasury and SARS explained that the MLI is aimed at updating the existing network of bilateral tax treaties (more than 3 000 tax treaties worldwide) to reduce opportunities for tax avoidance and base erosion by multinational enterprises.

> "It is important to appreciate that the MLI can only become part of South African law once it has been ratified, which also applies to the DTAs to which the MLI will apply."

APPLICATION OF THE MLI TO SOUTH AFRICA'S DTAS

South Africa has listed 76 DTAs to be covered by the MLI. Once the countries that are party to these DTAs have ratified the MLI, the relevant parts of the agreements that are affected will be consistent with the tax-related BEPS measures without the need for any of the DTAs to be renegotiated. National Treasury and SARS indicated that, as at 11 August 2021, 42 of the 76 countries that are party to DTAs with South Africa had ratified the MLI. It was further noted that five of South Africa's DTAs would not be covered by the MLI, as they are either currently being renegotiated with BEPS recommendations being incorporated into them (Germany, Malawi and Zambia) or are incompatible with the MLI (Grenada and Sierra Leone).

URGENCY IN RATIFYING THE MLI

National Treasury and SARS indicated to the SCOF that one of the measures adopted by the Inclusive Framework (countries collaborating on the implementation of the OECD/G20 BEPS package) for the monitoring of the implementation of the OECD/G20 BEPS package is the peer review process. The peer review for the implementation of the BEPS Action 6 Report, dealing with tax treaty abuse, has already started.

The implementation of this Action 6 Report is dependent upon Inclusive Framework member countries (of which South Africa is one) having ratified and implemented the MLI or having renegotiated their treaties in accordance with its principles. As South Africa has not yet ratified and implemented the MLI, South Africa has already earned a negative point in the Action 6 peer review. Therefore, National Treasury and SARS indicated that the ratification of the MLI is important for South Africa to remain compliant with the OECD/G20 BEPS minimum standards and address BEPS in South Africa.

"In their appearance before the SCOF, National Treasury and SARS explained that the MLI is aimed at updating the existing network of bilateral tax treaties (more than 3 000 tax treaties worldwide) to reduce opportunities for tax avoidance and base erosion by multinational enterprises."

SOUTH AFRICA'S MLI ADOPTION IN THE FINAL STRAIGHT

Following the appearance of National Treasury and SARS before the SCOF on 25 May 2022 and their presentation of the MLI to the SCOF for consideration, they also appeared before the Select Committee on Finance of the National Council of Provinces on 21 June 2022. It therefore appears that the actual adoption and ratification of the MLI may be imminent. It is important to appreciate that the MLI can only become part of South African law once it has been ratified, which also applies to the DTAs to which the MLI will apply. This is because in terms of section 231 of the Constitution of the Republic of South Africa, 1996, an international agreement will only be binding on South Africa once it has been approved by resolution in both the National Assembly and the National Council of Provinces, unless it is a self-executing treaty that does not require ratification.

Louis Botha

Cliffe Dekker Hofmeyr

Acts and Bills

- Constitution of the Republic of South Africa, 1996: Section 231.

Other documents

- Base Erosion and Profit Shifting (BEPS) Multilateral Instrument (MLI) (signed by South Africa on 17 June 2017, but not yet ratified);
- Action 6 Report (BEPS report dealing with tax treaty abuse).

Tags: base erosion and profit shifting (BEPS); double tax agreements (DTAs); tax-related BEPS measures; BEPS Action 6 Report.

FILING DEADLINES FOR 2022

The efficient and effective administration of tax is a fundamental, although often vilified, aspect of any well-functioning tax system. The ability for taxpayers to provide revenue authorities with information about their income and expenditure easily, fully and reliably is the starting point of a sound tax administration.

On 3 June 2022, Public Notice 2130 of 2022 (PN2130) was published by the Commissioner for the South African Revenue Service (the Commissioner). PN2130 contains important information for all taxpayers because it sets out the categories of taxpayers required to submit returns for the 2022 year of assessment and the dates by which such returns are to be submitted.

TAX RETURNS UNDER THE TAA

Section 25 of the Tax Administration Act, 2011 (the TAA), requires taxpayers to submit returns either voluntarily, as required by a tax Act or as required by the Commissioner and by the date specified in the tax Act or in the public notice requiring submission.

"The ability for SARS to target its resources is a positive development for the administration of tax in South Africa, as this is an indication of the capacity of the revenue authority to assess non-controversial taxpayers."

"From a taxpayer perspective, the importance of submitting tax returns (specifically within stipulated deadlines) is supported by the sanctions that SARS can impose to the extent that these obligations are not complied with."

In the context of income tax also known as normal tax, section 66(1) of the Income Tax Act, 1962, requires the Commissioner to annually issue a public notice indicating the persons who are required to furnish returns for the assessment of normal tax within the period prescribed in such notice.

The concept of a return under the TAA is fundamental to the assessment procedure and dispute resolution processes available to taxpayers. A "return" is defined in section 1 of the TAA as:

> "A form, declaration, document or other manner of submitting information to SARS that incorporates a self-assessment, is a basis on which an assessment is to be made by SARS or incorporates relevant material required…"

The fact that a return is the basis upon which an assessment is made, indicates the importance of the return process in tax administration, because without the information provided in returns, the revenue authority would be deprived of a primary source of information regarding taxpayers' relevant affairs.

This is underlined by the fact that, where a return includes a self-assessment of the tax liability, such a return constitutes an original assessment as per the provisions of section 91 of the TAA.

SANCTIONS CAN BE IMPOSED BY SARS IF TAX RETURNS ARE NOT DULY SUBMITTED BY TAXPAYERS

From a taxpayer perspective, the importance of submitting tax returns (specifically within stipulated deadlines) is supported by the sanctions that SARS can impose to the extent that these obligations are not complied with. Where taxpayers fail to submit returns by the relevant deadline, the South African Revenue Service (SARS) is (under certain circumstances) empowered to issue an assessment of the amount of tax due and impose certain penalties.

For example, if a taxpayer fails to submit a return, section 95 of the TAA empowers SARS to issue an assessment based on an estimate, using information readily available to SARS. Such an estimated assessment can only be challenged once the taxpayer has duly submitted the outstanding return.

In addition to being able to issue an assessment which will result in the taxpayer being liable for amounts of tax, SARS may levy administrative non-compliance penalties under section 210 and understatement penalties under section 222 of the TAA.

SARS may impose an administrative non-compliance penalty where a taxpayer has failed to comply with their obligation to submit a return. These penalties are imposed for every month during which the non-compliance persists. The amount of the penalty is based on the taxpayer's assessed loss or taxable income for the preceding tax year. Where a taxpayer has an assessed loss, each monthly administrative non-compliance penalty may be R250, while where a taxpayer has taxable income of R50 000 001 or more, the penalty may be R16,000 per month.

SARS is similarly empowered to impose an understatement penalty, where the non-submission of a return has prejudiced SARS or the fiscus and resulted in a shortfall. Such a shortfall exists in circumstances where there is a difference between the amount of tax that would have been collected under a return submitted or outstanding, and the amount of tax that ought to be collected upon a proper application of the relevant tax legislation. The amount of the understatement penalty is determined based on the culpability of the taxpayer and ranges between 0% of the shortfall where the non-compliance is disclosed voluntarily before notification of audit or criminal investigation and 200% of the shortfall where the taxpayer is guilty of intentional tax evasion.

PUBLIC NOTICE 2130

PN2130 ("Returns to be submitted by a person in terms of section 25 of the Tax Administration Act, 2011") sets the parameters for the submission of tax returns for the 2022 year of assessment or tax year. For tax resident companies, the financial year ending during the calendar year of 2022 will be that company's 2022 year of assessment. However, for all other persons (eg, trusts, individuals), the 2022 tax year is the year of assessment ending during the period of 12 months ending on 28 February 2022. This allows taxpayers such as deceased estates or persons ceasing tax residence to be included in the 2022 year of assessment, despite the full tax year not being applicable to such persons.

In PN2130, the Commissioner sets out the following notable categories of persons required to submit returns and the dates by which these returns must be filed with SARS:

- Every trust which was tax resident in South Africa during the 2022 year of assessment;
- Any non-resident trust or juristic person that carried on a trade through a permanent establishment in South Africa, derived income or a capital gain or capital loss in South Africa; and
- Any representative taxpayer of persons falling into the categories noted in PN2130.

Persons noted in PN2130 as being specifically excluded from the requirement to submit returns, despite falling within a general category noted as required to submit returns, include:

- Natural persons that earned stipulated categories of gross income consisting solely of certain defined categories of income. Notably, remuneration not exceeding R500 000, from which employees' tax has been deducted or withheld; and
- Natural persons who are notified that they are eligible for automatic assessment and whose gross income, exemptions, deductions and rebates reflected in the records of the Commissioner are complete and correct as at the date of the assessment based on an estimate to give effect to automatic assessment.

PN2130 requires that companies submit their returns within 12 months of their financial year end. For all other taxpayers (eg, natural persons, trusts and other juristic entities) who are not provisional taxpayers, the submission must be done on or before 24 October 2022, whereas provisional taxpayers must submit their income tax return on or before 23 January 2023.

COMMENT

The submission of returns is a key aspect of a tax administration system. A timely submission of returns is an important step for a taxpayer's tax compliance. PN2130 therefore enables all taxpayers with South African tax obligations to understand the time in which they must compile the information necessary for an assessment and submit it to SARS.

The scope of taxpayers required to submit returns allows us some insight into the operations of SARS as a revenue authority. The exclusion of categories of taxpayers from the obligation to submit returns, does not mean that such taxpayers will not be assessed for tax. Rather, it is an indication that SARS is comfortable that it is able to acquire sufficient information to conduct an assessment of the liability of those categories of taxpayers. For example, where natural persons earn R500 000 or less in remuneration from a single source, and employees' tax was withheld or deducted, the risk of the information not being available to SARS is low, considering the employer PAYE returns that are filed with SARS.

The ability for SARS to target its resources is a positive development for the administration of tax in South Africa, as this is an indication of the capacity of the revenue authority to assess non-controversial taxpayers. This allows SARS to dedicate resources to more complex administrative matters that require more sophisticated resources.

Tsanga Mukumba

Cliffe Dekker Hofmeyr

Acts and Bills

- Income Tax Act 58 of 1962: Section 66(1);
- Tax Administration Act 28 of 2011: Sections 1 (definition of "return"), 25, 91, 95, 210 & 222.

Other documents

- Public Notice 2130 ("Returns to be submitted by a person in terms of section 25 of the Tax Administration Act 28 of 2011" – *GG* 46471 (3 June 2022)).

Tags: self-assessment; administrative non-compliance penalties; understatement penalty; natural persons; non-controversial taxpayers.

SECTION 9 OF THE TAX ADMINISTRATION ACT AS AN "INTERNAL REMEDY"

Section 9(1) of the Tax Administration Act, 2011 (the TAA), effectively provides for a taxpayer to request a South African Revenue Service (SARS) official to withdraw or amend either a decision made by a SARS official, or a notice issued to the taxpayer.

Excluded from this provision are decisions given effect to in an assessment or a notice of assessment that are subject to objection and appeal in terms of Chapter 9 of the TAA.

For example, where a taxpayer has unsuccessfully applied for a suspension of payment in terms of section 164 of the TAA, which decision is not subject to objection and appeal under Chapter 9, the taxpayer may request that SARS reconsider its negative decision.

"Regardless of whether section 9 creates an 'internal remedy', it seems to be a common occurrence that taxpayers nevertheless exhaust section 9 prior to approaching the court for relief under PAJA."

PAJA AND EXHAUSTION OF INTERNAL REMEDIES

Generally, where a decision by SARS is not subject to objection and appeal, an aggrieved taxpayer would have to seek judicial review in terms of the Promotion of Administrative Justice Act, 2000 (PAJA), on the basis that the decision constitutes administrative action.

Section 7 of PAJA specifically provides that a court may not review administrative action unless "any internal remedy provided for in any other law has first been exhausted" – this is why a decision that is subject to objection and appeal in terms of Chapter 9 of the TAA does not generally qualify for judicial review. The objection and appeal procedures are considered "internal remedies".

The court in *Reed and Others v The Master of the High Court of South Africa and Others,* [2005], defined an "internal remedy" as an "administrative appeal … to an official or tribunal within the same administrative hierarchy as the initial decision-maker – or less common, an internal review". The Supreme Court of Appeal agreed with this definition in *DDP Valuers (Pty) Ltd v Madibeng Local Municipality,* [2015].

The question that arises is whether section 9 provides for an "internal remedy" and, more specifically, whether it must first be exhausted before proceeding with a review application under PAJA.

SECTION 9 IN PRACTICE

Regardless of whether section 9 creates an "internal remedy", it seems to be a common occurrence that taxpayers nevertheless exhaust section 9 prior to approaching the court for relief under PAJA. The taxpayers in the cases of *Medtronic International Trading SARL v Commissioner, South African Revenue Service,* [2021], and *Absa Bank Ltd and Another v Commissioner, South African Revenue Service,* [2021], both sought review of the refusal by SARS to withdraw its decision or notice in terms of section 9.

In the *Medtronic* case, the taxpayer approached the court to review SARS' refusal to withdraw its decision in respect of the taxpayer's request for remission in terms of section 39(7)*(a)* of the Value-Added Tax Act, 1991. Similarly, in the *Absa Bank* case, the court grappled with the issue of refusal by SARS to withdraw a notice given in terms of section 80J of the Income Tax Act, 1962. The

court in *Absa Bank* went into more depth regarding section 9 in discussing how it relates to decisions not yet given effect to. As a matter of interest, the *Medtronic* case has been taken on appeal by SARS and was set down for hearing by the Supreme Court of Appeal (SCA) in August 2022. It remains to be seen whether the SCA will touch upon the interpretation and application of section 9.

That being said, there appears to be no reported judgment where a court has refused to review administrative action by SARS under PAJA on the basis that the taxpayer did not first request a withdrawal or amendment in terms of section 9.

"That being said, there appears to be no reported judgment where a court has refused to review administrative action by SARS under PAJA on the basis that the taxpayer did not first request a withdrawal or amendment in terms of section 9."

One should also keep in mind that, even if section 9 creates an explicit internal remedy, not exhausting this remedy does not absolutely exclude courts from reviewing the relevant administrative action. Section 7(2)*(c)* of PAJA provides for an exemption in exceptional circumstances where it is in the interests of justice.

SECTION 9 AS AN EMPOWERING PROVISION RATHER THAN AN INTERNAL REMEDY

As opposed to viewing section 9 as an "internal remedy", one should also consider the nature of section 9 as simply an empowering provision which allows SARS officials to revisit their decisions. The court in *ITC 1946* [2019] 83 SATC 504 considered the nature of section 9 and provided some valuable insight into the nature of this provision. The court noted that the provision explicitly provides that the withdrawal or amendment of a decision or notice can be done at the discretion of a SARS official and not only at the request of a relevant person. The court held that this implies that withdrawal or amendment need not particularly be to the benefit of the taxpayer and can be exercised adversely to the taxpayer. The section therefore not only provides a remedy to taxpayers, but is perhaps more fundamentally a provision empowering SARS officials to revisit their decisions (not leaving them *functus officio*).

Heinrich Louw

Cliffe Dekker Hofmeyr

Acts and Bills

- Tax Administration Act 28 of 2011: Section 9 (more specifically subsection (1)); Chapter 9 (sections 101–150); section 164;
- Promotion of Administrative Justice Act 3 of 2000: Section 7 (more specifically subsection (2)*(c)*);
- Income Tax Act 58 of 1962: Section 80J;
- Value-Added Tax Act 89 of 1991: Section 39(7)*(a)*.

Cases

- *Reed and Others v The Master of the High Court of South Africa and Others* [2005] (2) All SA 429 (E); 2005 JDR 0538 (E);
- *DDP Valuers (Pty) Ltd v Madibeng Local Municipality* [2015] JDR 2093 (SCA);
- *Medtronic International Trading SARL v Commissioner, South African Revenue Service* [2021] JDR 0490 (GP); 83 SATC 281;
- *Absa Bank Ltd and Another v Commissioner, South African Revenue Service,* [2021] (3) SA 513 (GP);
- *ITC 1946* [2019] 83 SATC 504.

Tags: notice of assessment; administrative action; internal remedies.

SARS POWERS TO COLLECT TAX DEBTS VIA THIRD PARTIES

The South African Revenue Service (SARS) has the powers to appoint third parties to collect outstanding tax debts from a taxpayer's retirement or salary payments.

Lump sums, monthly annuities and salaries are not off-limits to the long arm of the taxman. Taxpayers who have failed to pay their tax debts in full to SARS should not be surprised if SARS moves to recover what it is owed from retirement fund administrators or employers using the third-party appointment process.

SARS' POWERS TO WITHHOLD FUNDS

SARS can require an employer or retirement fund administrator to hold back / deduct outstanding tax debts of an individual through the third-party appointment process set out in section 179 of the Tax Administration Act, 2011 (the TAA). SARS may appoint third parties such as employers, retirement fund administrators, banks, insurance companies, investment managers and debtors to deduct the outstanding tax debts from any money held for, owed to or to be paid to the individual and to pay the amounts deducted to SARS. Effectively, these third parties are appointed as "agents" to deduct and pay to SARS the outstanding tax debts.

SARS must send a final letter of demand to the taxpayer at least ten business days before instituting the third-party agent appointment process (unless the final demand would prejudice the collection of the tax debt). SARS must ensure that the letter of demand is "received" / delivered on the taxpayer's eFiling profile.

In *SIP Project Managers (Pty) Ltd v Commissioner for the South African Revenue Service,* [2020], and *WPD Fleetmas CC v Commissioner for the South African Revenue Service and Another,* [2020], the High Court ruled that the third-party appointment processes were unlawful as SARS did not prove that the final letters of demand were delivered to the taxpayers' eFiling profile. The High Court found that the direct debits on the taxpayers' bank accounts were unlawful and SARS was required to refund the amounts.

The third-party agent appointment process is thus a collection process by SARS after it has issued a final letter of demand, but the taxpayer has still not paid the outstanding tax debts.

THE MECHANISMS FOR COLLECTION

1. Deductions from lump sums

When an individual resigns, is retrenched or retires from their employment, their pension or provident fund will apply to SARS for a directive on the amount of PAYE to be withheld from the lump sum payments (on resignation or retrenchment) or lump sum withdrawals (on retirement). A retirement annuity fund administrator will also be required to apply for a directive from SARS on the amount of PAYE to be withheld from the lump sum withdrawals on retirement.

SARS will issue an IT88L directive for an amount deductible as PAYE by the retirement fund administrator for the income tax amounts due from the lump sum payments/withdrawals, existing income tax debts, administrative penalties, and provisional taxes owed by an individual. The IT88L effectively acts as a "stop order for taxes in arrears" for the retirement

fund administrator to deduct the tax debts from the lump sum amounts and pay them to SARS.

2. Deductions from monthly annuity/pension payments

The amount a taxpayer receives in the form of monthly annuities from a retirement fund is "remuneration", and subject to PAYE. These amounts can also be targeted by SARS.

SARS can appoint the retirement fund administrator as its third-party agent to collect tax debts. Effectively, the retirement fund administrator is the "employer" responsible for withholding PAYE on the annuities / remuneration payable to the taxpayer.

The monthly pension or annuity can potentially be subject to third-party appointment letters by SARS in the form of the AA88 Third Party Appointment Notice. These AA88 notices instruct the retirement fund administrators to deduct the specified tax debt amounts against the monthly annuities and pay them to SARS by the due dates.

If the taxpayer has accumulated their monthly annuities in a money market account over time, SARS can also issue a third-party appointment letter to the bank requiring it to deduct any outstanding tax debts from the money market account and pay it to SARS.

"The third-party agent appointment process is thus a collection process by SARS after it has issued a final letter of demand, but the taxpayer has still not paid the outstanding tax debts."

3. Deductions from salaries

SARS can also issue the AA88 notices to employers on the e@syFile™ system with similar instructions to deduct specified tax debt amounts from the salaries of the listed employees. If an employer does not comply with the AA88 instructions, the employer will be personally liable for the amounts not deducted.

The employer can post an outcome on an employee and send it to SARS without deducting the amount in the AA88 instruction. These outcomes could be, for example, if the taxpayer's employment is not confirmed or they are not employed, the taxpayer is deceased or insolvent, or there is an affordability request to reduce the amount to be deducted based on "basic living expenses" needed by the employee and their dependants.

While the IT88L represents a "stop order" on the lump sums, the AA88 agent appointments are issued to employers until the tax debts of an individual are proven to be paid up by the individual, in which case the employer will finalise and cancel the AA88 instruction and stop further deductions.

PAY TAX DEBTS BY THE DUE DATES

SARS has very broad powers to collect outstanding tax debts. Tax debts should be paid to SARS by the due dates to avoid SARS exercising its third-party collection processes.

Joon Chong

Webber Wentzel

Acts and Bills

- Tax Administration Act 28 of 2011: Section 179.

Other documents

- IT88L (Notice attached to a tax directive issued by SARS (it effectively acts as a "stop order for taxes in arrears"));
- AA88 Third Party Appointment Notice (issued by SARS, also to employers on the e@syFile™ system).

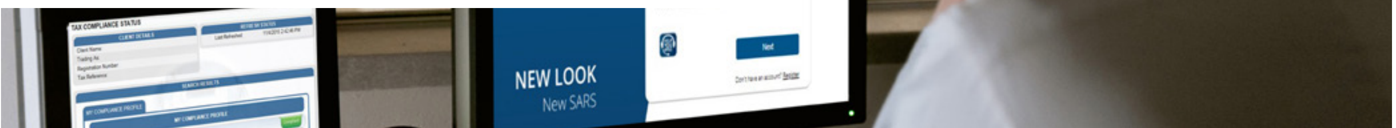
Cases

- *SIP Project Managers (Pty) Ltd v Commissioner for the South African Revenue Service* [2020] ZAGPPHC; JDR 1093 (GP); Case No 11521 [2020] (30 April 2020);
- *WPD Fleetmas CC v Commissioner for the South African Revenue Service and Another* [2020] ZAGPPHC; Case No 31339 [2020] (19 August 2020).

Tags: final letter of demand; IT88L directive; third-party appointment letters; outstanding tax debts.

THE SARS AUTO-ASSESSMENT PROCESS

The SARS Filing Season 2022 brought with it a new SARS auto-assessment process.



The SARS Media Statement on the 2022 Tax Filing Season, issued on 29 June 2022, explains that SARS has assessed over three million individual non-provisional taxpayers who "will not have to file a tax return if they are satisfied with the outcome". The Media Statement then further explains how SARS is making it easy and seamless for most individual taxpayers to comply with their legal obligations.

But what exactly does this entail? Is it permissible in terms of tax legislation and are there any red flags for taxpayers?

During the 2021 Filing Season, SARS implemented the use of pre-populated income tax returns for many individuals. However, the 2022 process is substantially different from the 2021 process. In 2021, the assessment was not issued until the taxpayer accepted the pre-populated return or made changes and submitted a revised return. One can only assume that this process did not yield the intended results and did not speed up the assessment process to the extent envisaged.

Hence, in the 2022 Filing Season, the new process works as follows:

- It should only apply to individual taxpayers who are non-provisional taxpayers, typically in formal employment.
- SARS sends an SMS and/or email to inform the taxpayer of the auto-assessment.
- Refunds are to be paid to taxpayers within 72 business hours, while amounts due to SARS should be paid by the stipulated date.
- If the taxpayer is satisfied with the auto-assessment, no further input from the taxpayer is required.
- However (and this is where a potential red flag comes in), if the taxpayer is of the view that any information is missing and/or inaccurate, the taxpayer must within 40 business days from the date of the auto-assessment notification, submit a revised tax return to SARS.

Many articles about the auto-assessment process seem to treat this as only a procedural change, but it is important for taxpayers to understand that there is a fundamental difference between the two.

While the 2021 pre-population process *ended* with the issuance of an assessment (after acceptance of the return by the taxpayer), the 2022 auto-assessment process *commences* with the issuance of an assessment. Should the taxpayer fail to submit a revised return within 40 business days, the assessment will become final; this is unless SARS grants an extension for the submission of the revised return or unless the taxpayer submits an objection.

It is unclear in terms of which legislative provision auto-assessments are being issued. The Tax Administration Act, 2011 (the TAA), does not refer to "auto-assessments" but provides for the issuance of –

- "jeopardy assessments" (section 94), if SARS is satisfied that this is required to secure the collection of tax that would otherwise be in jeopardy; or
- "estimated assessments" (section 95), if the taxpayer did not submit a return, or if the return is incorrect or inadequate.

The fact that taxpayers are afforded 40 business days to issue a revised return seems to indicate that auto-assessments are being issued in terms of section 95 of the TAA. However, can it be said that a taxpayer did not submit a return if it did not have sufficient (or any) time to submit a return before an auto-assessment was issued?

Also, section 95(4) states that the making of an assessment does not detract from the obligation to submit a return, while the SARS Media Statement states that "if a taxpayer is satisfied with the auto assessment, they don't have to do anything further and the process terminates at this point".

Justification for the non-submission of tax returns seems to come from Notice No 46471, published in the *Government Gazette* on 3 June 2022, in terms of which taxpayers are not required to submit

"The SARS Media Statement on the 2022 Tax Filing Season, issued on 29 June 2022, explains that SARS has assessed over three million individual non-provisional taxpayers who 'will not have to file a tax return if they are satisfied with the outcome.' "

returns if they have been notified by SARS that they are eligible for automatic assessment, and if the auto-assessment correctly reflects the person's gross income, exemptions, deductions and rebates.

So where is the harm in respect of this process? Surely any process that helps to take the pain out of tax compliance should be welcomed?

All is well if the return contains the correct information and/or if the taxpayer receives the notification of the auto-assessment and is able to timeously submit a revised return.

However, the problem arises where some information is missing, for example, if the taxpayer has made deductible donations or incurred expenditure that is not included in third-party returns and thus not taken into account by SARS. For example, according to media reports, SARS has disallowed 60% of the home office expenses claimed in respect of the 2021 tax year. Information regarding these types of expenses will obviously not be available to SARS for the purpose of an auto-assessment, which means that the taxpayer would have to submit a revised return within 40 business days. The same applies should the taxpayer have received income that is not included in the auto-assessment.

Another very important concern is that a taxpayer may overlook an SMS or email from SARS regarding an auto-assessment. The taxpayer may have failed to ensure that SARS has its correct contact details on record, or the email may have been blocked or treated as junk mail.

The fact that e-fraudsters have already jumped on the tax bandwagon is not helpful in this regard. Fraudsters have already been sending SMSs to taxpayers, notifying them of purported tax liabilities and, more tempting, a potential tax refund with a handy link to what is presumably a scam website.

Taxpayers will thus have to be even more vigilant, checking their emails, SMSs and eFiling profiles for an auto-assessment, carefully scrutinising any auto-assessment for accuracy, and ensuring that they have the information at hand in order to timeously submit a revised return if required.

Aneria Bouwer

Bowmans

Acts and Bills

- Tax Administration Act 28 of 2011: Sections 94 (jeopardy assessments) & 95 (estimated assessments).

Other documents

- SARS Media Statement on the 2022 Tax Filing Season, issued on 29 June 2022;
- Notice No 46471, published in the *Government Gazette* on 3 June 2022.

Tags: pre-populated income tax returns; non-provisional taxpayers; revised return.

THE SARS SERVICE CHARTER

SARS released their latest *Service Charter* on 9 May 2022, with an effective date of 1 April 2022. In it, SARS states that it will do certain things within certain time periods; they will, for example –

- pay out refunds within 72 hours in 90% of cases under certain circumstances;
- conclude audits within 90 business days in 90% of cases in certain circumstances; and
- make a decision on a request for suspension of payment within 30 business days under certain circumstances, etc.

For things like the payment of refunds, the completion of audits and decisions on requests for suspension of payment where the Tax Administration Act, 2011 (the TAA), does not prescribe fixed time periods, these undertakings are very welcome! SARS is indeed to be commended for trying to commit to time periods where the TAA is silent as regards time periods. However, commitments to comply with legislatively prescribed time periods in, say, only 50% of cases, is a bit worrying.

When it comes to tax dispute resolution (objections and appeals), there are prescribed time periods within which SARS (and also taxpayers) must do certain things. For example:

- Where a taxpayer requests reasons for an assessment, SARS must provide the reasons within 45 business days from the date of the request (unless SARS believes sufficient reasons have already been provided, in which case they must inform the taxpayer of that within 30 business days);
- SARS must make a decision on an objection within 60 business days from the date of submission of an objection (subject to a couple of exceptions, for example, if SARS requested supporting documents or where the case is complex, and SARS notifies the taxpayer that they are unilaterally extending the time period);
- Where a taxpayer opts for alternative dispute resolution (ADR) on appeal, SARS must give notice to the taxpayer of their agreement to ADR proceedings within 30 business days from the submission of an appeal;
- Where a taxpayer is following the ADR process on appeal, the ADR process must be concluded within 90 business days from the date on which SARS notifies the taxpayer that it agrees to ADR proceedings, etc (unless otherwise agreed).

"In short, if your case falls into the 10% to 50% of cases where SARS does not stick to prescribed time periods and it is not good enough, taxpayers have a choice to either accept it or not to accept it by taking the appropriate steps to restore balance and fairness."

In their latest service charter, it appears as if SARS is committing to comply with the above-mentioned prescribed time periods in 50% to 90% of cases. What is to be made of such undertakings?

Should this be understood to mean that in between 10% and 50% of cases SARS will not try to stick to prescribed time periods? Let us hope that is not the case! Perhaps it should be understood that

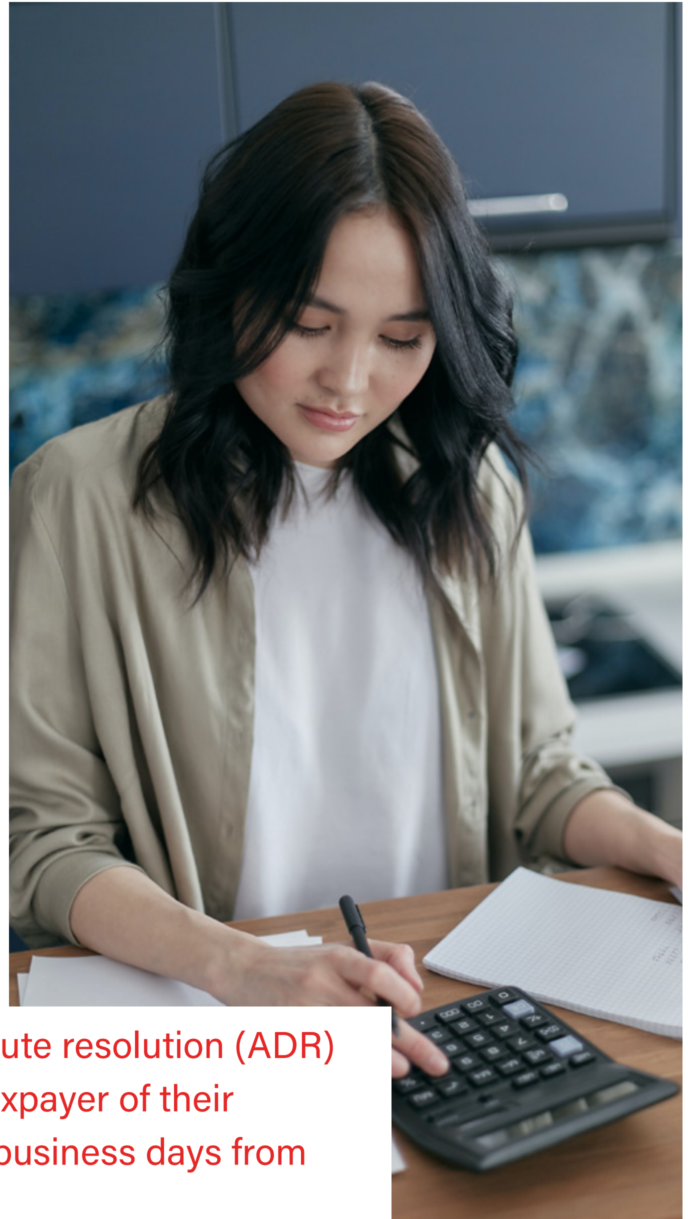
SARS will commit to always stick to prescribed time periods and that if they do not, taxpayers should know that it is the exception, rather than the rule? Let us assume the latter and then ask the further question – is it good enough to aim for a 50% to 90% compliance rate with prescribed time periods?

Well, perhaps, if that is also what is expected of taxpayers? In the same service charter SARS states that taxpayers have an obligation to "*Timeously* engage … and comply with legal obligations" [own emphasis]. No margin for error there? Having said that, and to be fair, there are many taxpayers who do not comply with prescribed time periods and, if one had access to such data, perhaps the data will show a much higher level of non-compliance by taxpayers with prescribed time periods that is nevertheless tolerated by SARS? But even if that were the case, one would expect, to use the words of the court, in *South African Revenue Service v MMY,* [2014]:

> "SARS, in particular, [to] take the lead and show efficiency" and to "…comply with time periods".

Whether this level of compliance with prescribed time periods or at least the level of compliance SARS is aspiring to achieve is good enough is something best left to each taxpayer to answer.

Taxpayers should know though that if it is not "good enough", there are remedies available and at their disposal in the case of non-compliance by SARS with prescribed time periods to restore balance and fairness. In short, if your case falls into the 10% to 50% of cases where SARS does not stick to prescribed time periods and it is not good enough, taxpayers have a choice to either accept it or not to accept it by taking the appropriate steps to restore balance and fairness.



"Where a taxpayer opts for alternative dispute resolution (ADR) on appeal, SARS must give notice to the taxpayer of their agreement to ADR proceedings within 30 business days from the submission of an appeal."

Nico Theron

Unicustax

Acts and Bills

- Tax Administration Act 28 of 2011.

Other documents

- *Revised Service Charter* (issued by SARS on 9 May 2022, with an effective date of 1 April 2022).

Cases

- *South African Revenue Service v MMY* [2014] (Case No 12013/2012) (13 February 2014).

Tags: requests for suspension of payment; alternative dispute resolution (ADR).

TRANSFER PRICING COMPLIANCE

Being subject to a tax audit from SARS is a tax manager's worst nightmare. When that audit is on the transfer pricing policies of the company, the nightmare gets worse! In this article, we discuss ways of preparing for an investigation into your transfer pricing practices.

The starting point for any audit is the disclosures made in the income tax returns (ITR14s). Taxpayers must indicate in their ITR14s whether they form part of a multinational enterprise (MNE) and provide relevant details of the intercompany transactions that were concluded during the year of assessment. Making an incorrect disclosure could amount to a "non-disclosure of material facts", which results in a waiver of prescription. This means that SARS would be free to audit a year of assessment even beyond the normal three-year prescription period. It may also place you in a difficult position regarding the imposition of penalties, should the audit result in an adjustment to taxable income. It is therefore prudent for taxpayers to provide proper disclosure in their ITR14s. However, this declaration, coupled with National Treasury's and SARS' collective efforts in addressing Base Erosion Profit Shifting (BEPS), which have intensified in recent years due to South Africa's slow economic growth and poor tax revenue collections, makes it essential for multinationals to adequately prepare for a potential audit of their transfer pricing practices.

Unfortunately, there is no way of guaranteeing that your business will never be audited. However, in this article, we discuss ways of preparing for and navigating SARS' investigation process to reduce the risk of a protracted transfer pricing audit and a potential adjustment.

1. Ensure you are compliant

In terms of the BEPS Action Plan adopted in 2013 by the OECD and the G20 countries (including South Africa), country-by-country (CbC) reporting was developed. South Africa adopted these guidelines and has brought in compulsory transfer pricing documentation requirements where the aggregate of a resident company's transactions value (without set-off) with offshore connected parties exceeds R100 million for that year

"The starting point for any audit is the disclosures made in the income tax returns (ITR14s)."

of assessment. The documentation provides SARS, and other tax authorities with which it shares this information, with the basis to conduct thorough transfer pricing risk assessments. It is therefore imperative that such documentation is prepared and filed.

2. Put your best foot forward

Transfer pricing documentation prepared by an MNE, with or without the assistance of a transfer pricing advisor, should be kept and filed in terms of South Africa's domestic regulations. However, such documentation should not be viewed as a simple compliance process. The documentation is essential for supporting the arm's length nature of these transactions.

If not already filed, your transfer pricing policy will be one of the first documents that SARS will request in a transfer pricing audit. To avoid having to respond to irrelevant questions and a protracted investigation process that is likely to absorb significant time and resources, the policy must adequately delineate the factual arrangements and information related to transactions with offshore connected parties in line with the underlying legal agreements.

Fundamentally, the documentation provides the context for how each party fulfils its contractual obligations stated in the underlying agreements. From this information it is possible to ascertain who does what, how the risks associated with the transactions are shared and what, if any, valuable assets are utilised. Getting this wrong may not only undermine your position in an audit, but also increases the risk of penalties being imposed should an adjustment be made.

Multinationals must ensure that the adoption of the preferred transfer pricing methods is sufficiently substantiated in the documentation; that the benchmarking and economic analyses are recent; and that the functional analyses are still relevant. The simpler and more user-friendly the transfer pricing document is, the better.

3. Importance of legal agreements

Although it is not essential, it is good business practice to have intercompany agreements governing the transactions. Make sure that these agreements are well-documented and accurately reflect the nature of the transactions and the roles and obligations of the parties. The agreements, when read in conjunction with the transfer pricing documentation, should provide the full picture and allow the reader to fully understand the nature of the transaction, the shared functions, risks, and assets used, as well as the contractual obligations of the parties.

We urge multinationals to make sure that the legal agreements are up to date and that the transfer pricing document aligns with those agreements. If there is a disparity between the agreements and the transfer pricing document, it will inevitably lead to increased scrutiny by SARS.

4. Be proactive in managing your transfer pricing policy

A regular assessment of your intercompany transactions, the pricing structure and allocation of related risks and functions is important to ensure compliance with South Africa's domestic transfer pricing rules.

Check that the documented analysis aligns with the related legal agreements and that both accurately reflect the pricing, terms and risks of the affected transactions. If the document analysing and supporting the transfer pricing differs either from the legal agreements in effect, or the conduct of the parties, SARS is likely to disregard the analysis and draw its own conclusions.

Make sure your policy is up to date, the benchmarking is relevant and that you have checked the results to ensure the pricing or outcome falls within the ranges identified. It is much harder to justify results three or four years after the fact in an audit situation than proactively correcting the position in real time.

If a possible risk is detected through a self-assessment, a voluntary self-correction is always preferable to an adjustment being made by SARS with penalties and interest at the conclusion of an audit.

5. Hot topics

Certain areas tend to attract greater scrutiny from tax authorities. However, the absence of these does not mean you are not at risk. Vanilla buy-sell arrangements can also be subject to transfer pricing audits.

Any form of restructuring or reorganisation within a corporate group is likely to be scrutinised, as this inevitably results in the reallocation of significant functions and risks. Such reorganisations must be driven by sound business principles and may be challenged by SARS if the reallocation lacks economic substance. It is therefore essential that MNEs make sure that their transfer pricing policies still accurately describe and support the economic substance of the allocation of risks after a restructure. If a function is moved, ensure that the people responsible for that function and for managing the risks around that function are also moved. When there has been a transfer of something of value, the transferring entity should be rewarded on an arm's length basis.

SARS published a Draft Interpretation Note on the Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans on 11 February 2022. This note clarifies that there are no longer any safe harbours to rely on in terms of the level of debt funding that SARS will accept, or the interest rates charged. SARS has confirmed that both the quantum and the pricing of an intra-group loan must adhere to the arm's length principle. Now is an opportune time for you to review all cross-border intra-group loan arrangements and prepare support for these arrangements being at arm's length, from both the lender's and the borrower's perspective.

Intellectual property transactions are becoming one of the key hot topics for tax authorities globally, with several key multinationals facing significant tax adjustments following audits. SARS will not be far behind on this trend. Key considerations are that development, enhancement, maintenance, protection and exploitation (DEMPE) activities relating to the intangibles are reviewed and should be carefully documented. The important lesson from recent transfer pricing case law on intercompany transactions relating to intangibles is that intercompany agreements must support the taxpayer's position on the ownership, marketing, and licensing of intellectual property, and that these agreements must be aligned with the group's transfer pricing analysis and the conduct of the parties.

In determining an arm's length profit allocation, the OECD recommends investigating which entity performs the DEMPE functions. The entity that legally owns the intangibles, assumes the DEMPE functions, and bears all the operational and financial risks, should be allocated a significant portion of the profits earned from those intangibles, while the more routine activities would only be awarded routine returns. Intangible returns should therefore be based on each entity's contribution. The internal management and governance of intangibles within a multinational group is imperative – transfer pricing documentation must accurately describe the transaction, define the intangibles involved and demonstrate that the profit allocation is aligned with the entities that own the intellectual property, contribute mostly to the DEMPE functions, and assume the most risk. If the entity assuming the risks differs from the entity that performs the DEMPE functions, a clear explanation must be given in the transfer pricing documentation.

"Intellectual property transactions are becoming one of the key hot topics for tax authorities globally, with several key multinationals facing significant tax adjustments following audits."

Tax authorities have also expressed a special interest in royalty payments that are linked to the leasing of intangible assets. Therefore, licensing arrangements must be correctly priced and benchmarking to support this must be held. Moreover, the ownership and transfer of intangibles between related parties, where one party is in a low-tax jurisdiction, as with all transactions, remain a significant audit focus.

6. Respond comprehensively to any initial queries

Even before you receive a notification of audit, SARS may well send information requests to get a better understanding of the transactions. Despite all the preparation that you do to ensure audit readiness, these initial requests for information are likely to be fairly wide-ranging and may include questions that you may consider to be irrelevant. However, we would urge multinationals to provide comprehensive responses to SARS' requests for two reasons:

- if SARS is unsatisfied with your response, it is likely to follow up with more questions; and
- a helpful response will contribute towards creating an amicable working relationship with SARS and may even satisfy them, avoiding the need for a full audit. If there is an amicable working relationship, SARS may also be more inclined to grant extensions in providing that information or consider penalty mitigation, should the initial queries lead to an audit which results in a transfer pricing adjustment.

Preparing for an audit requires putting your ducks in a row, having the correct documentation, and doing everything possible to support your transfer pricing practice as arm's length. While a complete avoidance of a transfer pricing audit cannot be guaranteed, it is in your interest to contact experts who have ample experience in assisting multinationals to assess their transfer pricing risk and in responding to transfer pricing queries from SARS. Such transfer pricing experts are able to guide and advise you to ensure the best possible outcome.

Carryn Alexander & Karen Miller

Webber Wentzel

Other documents

- ITR14;
- Draft Interpretation Note on the Determination of the Taxable Income of Certain Person from International Transactions: Intra-Group Loans (published by SARS on 11 February 2022).

Tags: waiver of prescription; country-by-country (CbC) reporting; transfer pricing risk assessments; transfer pricing policy; transfer pricing documentation; transfer pricing audits; arm's length profit allocation; transfer pricing adjustment.

TRANSFER PRICING: *McDONALD'S* CASE

Although we are not yet near the end of the year, 2022 has thus far provided some valuable lessons that can be learned from transfer pricing (TP) cases involving some of the world's best-known brands.

The latest to fall foul was McDonald's. In what has been confirmed as "the second-biggest tax settlement in French history", the American fast-food chain was ordered to pay €1.25bn ($1.3bn) to the French tax authorities (made up of a €508m fine and €737m in back taxes and penalties) to avoid prosecution over tax evasion said to have been carried out between 2009 and 2020.

The company was found to have been using brand fees/royalties as a way to shift profits to low-tax jurisdictions. Investigators found that it is a widespread practice in the multinational (MNE) group to have inconsistent policies regarding these fees; generally, the fees paid were based on how profitable a certain branch was. In this way, the more profitable, the more fees were paid out to an advantageous tax jurisdiction. With respect to the French operations, in particular, the royalties being paid to its parent company in Luxembourg were doubled in 2009 from 5% to 10% of restaurant turnover, a move which saw profits moved out of France to Luxembourg, which has significant tax benefits compared to France. While the company tried to justify this by referencing the increase in profits in France, both the commercial rationale and the economic substance in Luxembourg were found to be wanting, so their argument did not hold. It is reported that the TP documents and evidence required were "completely absent" and tax authorities could not find "any justification at all for the TP policy changes".

LESSONS LEARNT FROM MCDONALD'S

We have listed below some key lessons from the McDonalds case, together with the insight of many tax directors from other big corporations who weighed in on the ruling:

- This case has reiterated how important it is for MNEs to perform consistent (annual) reviews of their TP arrangements across the group, and to have documentation in place to support and defend its practices. This is particularly important to ensure that the pricing is still appropriate and fits within the business. Any discrepancy could lead to a large tax bill, which could have been prevented if the right documentation had been in place.

- In TP cases dealing with intellectual property (IP), royalty fees, and licensing of IP, documentation needs to be extremely robust. Evidence on the commercial rationale for inter-company terms must be clearly documented.

- Even with TP documentation in place and prices being within benchmarked ranges, corporations can still face a dispute, and therefore consistency and transparency remain key parameters.

- Many corporations confess that it can be difficult to assess and explain where the economic ownership (of IP) is. Lack of knowledge or understanding provides little defence against a tax authority onslaught. The onus is clearly on the taxpayer to figure their IP out.

- Many corporations are in favour of mitigating the risk of tax disputes by relying more on strategies such as dispute prevention methods such as advance pricing agreements (APAs) and mutual agreement procedures (MAPs) as a starting point.

- It is important to centralise the TP policy design and documentation as much as possible to avoid any nasty jurisdictional surprises during audits by tax authorities.

- Whilst central oversight is important, localisation cannot be overlooked. Finding the right balance is very important.

- TP documentation needs to be treated as "live" – people and businesses are ever evolving. TP is quicker than most...

- It is crucial to not only have legal agreements in place to govern intra-group transactions, but those legal agreements must accurately reflect the true nature of the transactions.

Don't take any risks. Contact experts in the field.

"The company was found to have been using brand fees/royalties as a way to shift profits to low-tax jurisdictions."

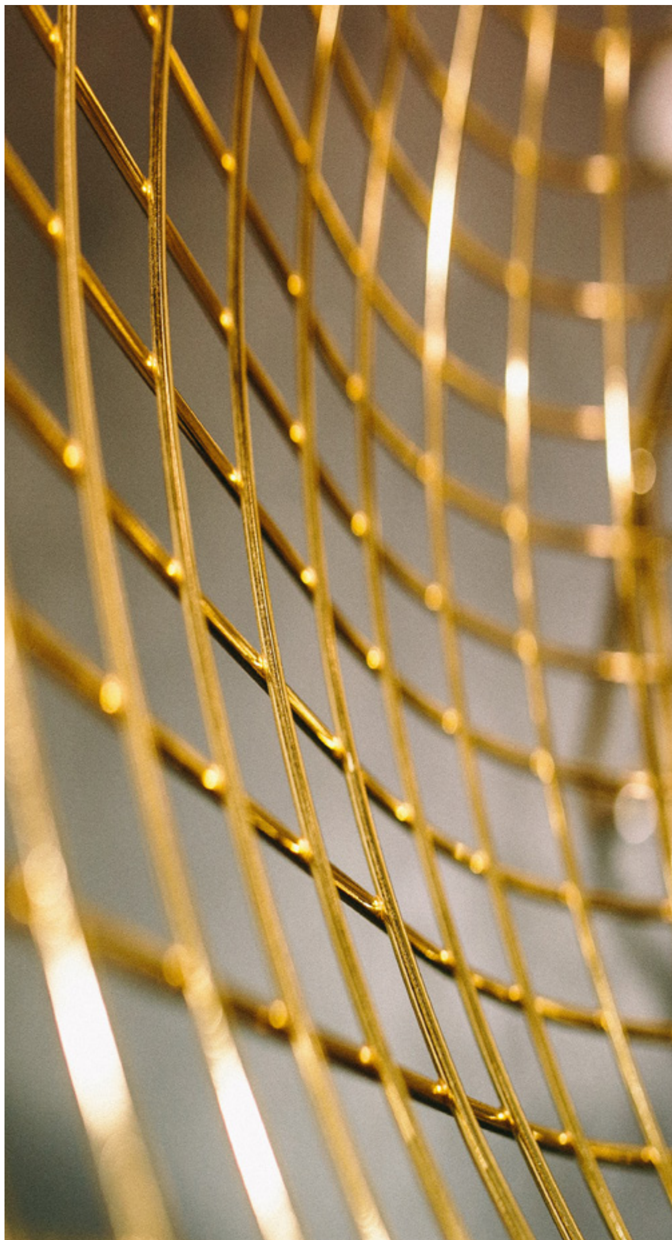
Tuli Nkonki

Regan van Rooy

Tags: advance pricing agreements (APAs); intra-group transactions.

REFINED SECOND-HAND GOLD

Gold is gold wherever in the world you buy it. Except if you buy it in South Africa and you happen to be a South African registered bank, the South African Reserve Bank (the SARB) or the South African Mint Company (Proprietary) Limited (the SA Mint), then you could find yourself paying 15% more in VAT depending on from whom you buy your gold.



By its very nature, gold is virtually indestructible and lends itself well to recycling. This means that all gold ever mined is still available above ground in one form or another. Its properties are universal such that each 1oz of gold, in whichever form it may be contained, is 100% interchangeable with any other 1oz of gold. This is most evident when gold is refined into a bullion bar with purity in excess of 99.5% (ie, pure gold). Bullion bars are often the subject of location swaps commonly occurring between the world's bullion banks whilst the physical gold bars themselves do not change hands.

Why then is it that when a bank, the SARB or the SA Mint acquires gold in South Africa from a mine the purchase qualifies to be zero-rated (taxed at a VAT rate of 0%) but when these same purchasers acquire gold from anyone else, such as another local bank or a second-hand gold refinery, the price is 15% higher as a result of VAT? Based on a recent judgment the answer, it would appear, depends on where the gold originates from.

ZERO-RATING OF GOLD

Section 11(1)*(f)* of the Value-Added Tax Act, 1991 (the VAT Act), provides that a transaction may be zero-rated if the supply is to a bank, the SARB or the SA Mint "of gold in the form of bars, blank coins, ingots, buttons, wire, plate or granules or in solution, which has not undergone any manufacturing process other than the refining thereof or the manufacture or production of such bars, blank coins, ingots, buttons, wire, plate, granules or solution".

Taken at face value, this provision zero-rates a supply of gold in any one of the eight prescribed forms to one of the three listed recipients.

GAME-CHANGING JUDGMENT

In the judgment of the High Court of South Africa, Gauteng Division, Pretoria in the matter of *Lueven Metals (Pty) Ltd v The Commissioner for the South African Revenue Service,* [2022], the court held that secondary refined and previously manufactured gold supplied to a bank, the SARB or the SA Mint does not qualify for zero-rating under section 11(1)*(f)* of the VAT Act.

The vendor, Lueven Metals (Pty) Ltd (Lueven), is a second-hand gold refinery incorporated in South Africa. It was common cause that Lueven produced gold bullion bars from second-hand gold material (eg, jewellery and scrap gold) for sale to Absa Bank Limited. It acquired second-hand gold which it partly refined in-house to produce gold bars with a purity of below 99.5% (lesser pure bars).

Lueven deposited the lesser pure bars at Rand Refinery Limited (Rand Refinery) for further refining, on its behalf, to produce pure gold bullion bars that meet the Good Delivery standards of the London Bullion Market Association (LBMA). Lueven itself is not LBMA-accredited. Rand Refinery, acting as its agent, then delivered the gold bullion bars to Absa on Lueven's behalf which Lueven zero-rated in terms of section 11(1)*(f)* of the VAT Act.

At the heart of the dispute was whether the phrase "which has not undergone any manufacturing process other than the refining thereof or the manufacture or production" (hereinafter referred to as "the restrictive phrase") precludes gold originating from secondary sources from being zero-rated when it is supplied as a refined bullion bar to a bank, the SARB or the SA Mint. The court was of the view that it does and made a declaratory order to that effect against the taxpayer.

WHICH GOLD?

But were the parties to the dispute referring to the same gold? Section 11(1)*(f)* refers to gold in eight prescribed forms, then uses the pronoun "which" before proceeding with the restrictive phrase.

The restrictive phrase bears a different meaning depending on whether one has in mind the gold sourced by the taxpayer (being secondary, unrefined gold which goes into the making of the final gold product), or the final gold product supplied to one of the listed recipients (being newly refined gold in one of the eight prescribed forms). It then becomes clear that there is a fundamental difference in VAT treatment depending on the kind of gold to which one believes the restrictive phrase applies.

The VAT treatment of a transaction depends on the type of goods or services *supplied.* For example, the supply of financial services is exempt from VAT whereas the supply of management services is taxable. When determining the VAT treatment of a *supply,* one does not consider the nature of any goods or services *acquired* to make that supply. Lueven therefore contended that the gold "which" may not have undergone any process of manufacture is the gold in one of the eight prescribed forms referred to in the section – *that* gold and, therefore, that section 11(1)*(f)* is a form preserving section.

SARS on the other hand contended that (any) gold "which" has previously been subjected to any manufacturing process at any time in the past (eg, scrap jewellery, or bars containing scrap gold) will not qualify for zero-rating and that the language of the section is clear.

WHO BENEFITS FROM ZERO-RATING?

The nail in the coffin for Lueven appears to have been SARS' contention that the policy rationale behind the section is to benefit the mining industry; thus that the only gold capable of qualifying for zero-rating under this section is newly mined gold. However, no evidence was proffered for such contention.

VAT is a consumption-based tax which means the final consumer (purchaser) bears the burden of the tax. If the purchaser is not VAT registered or cannot otherwise claim a full input tax deduction, the VAT incurred is a cost. It is therefore the *purchaser* who benefits from zero-rating. The impact of zero-rating is best illustrated with reference to the basket of zero-rated foodstuff which is aimed at providing tax relief to the poor (not the retailers selling the goods).

In the current matter, section 11(1)*(f)* affords zero-rating only to banks, the SARB or the SA Mint as this section does not apply to any other type of purchaser.

But let us take a look at what all of this means in practice.

FIRST JEOPARDY – HISTORIC ORIGIN AND BURDEN OF PROOF

Based on the interpretation of section 11(1)*(f)* as per the judgment, the only time when the origin of the gold can definitively qualify for zero-rating is if the gold is newly mined gold acquired from a mine. It would otherwise be impossible to establish whether a gold bar or any part thereof was previously subjected to any manufacturing process. In light of this judgment, banks, the SARB and the SA Mint will no longer be able to acquire (refined, recycled) gold on a zero-rated basis from second-hand gold refineries with peace of mind.

It matters not that newly mined gold and recycled gold could both be deposited at Rand Refinery at the same time, be co-mingled and co-refined to LBMA standards and then cast into a single gold bullion bar. As long as the supplier can prove that the gold originated from the mine from which it was extracted, it could zero-rate its sale of gold (in a prescribed form) to a listed recipient.

This was not previously understood to be a condition for zero-rating and the exact requirements for the seller to discharge its burden of proof are unclear. SARS' Interpretation Note 31 (Issue 4) ("Documentary proof required for the zero-rating of goods or services") does not cast any light on this matter as it lists only a "tax invoice" as documentary proof to support zero-rating under section 11(1)*(f)*.

SECOND JEOPARDY – RESIDUAL VAT COST FOR THE PURCHASER

If one takes a bank, for example, it provides a combination of VAT exempt/non-taxable supplies (eg, financial services) and other taxable supplies which means that it generally cannot claim the full amount of VAT incurred on its expenses. Banks acquire gold for various purposes, whether to hold as investments, reserves or to provide gold-backed investment products (eg, exchange-traded funds).

If the gold is acquired partly for VAT exempt/non-taxable purposes, the purchaser would not be able to claim the full amount of VAT incurred. Gold originating from secondary sources would be more expensive as any residual VAT which cannot be claimed will become a cost to the purchaser.

Residual VAT is often passed on by a vendor to its customer in the form of an inflated sales price. This gives rise to VAT cascading (ie, VAT at 15% is levied on the VAT cost that is embedded in the sales price). The problem is compounded if the next customer in the line is another bank (or the SARB or the SA Mint). Based on the judgment, bank 1 would not be able to supply gold at the zero rate to bank 2 (or the SARB or the SA Mint) as bank 1 would not be able

to prove the origin of the gold, especially if the gold is processed via Rand Refinery and thus co-mingled. This means gold can only ever be supplied *once* at the zero rate under section 11(1)*(f)*, being the very first sale of newly mined gold (in a prescribed form, to a prescribed recipient).

On the other hand, if the listed recipients are able to claim the full amount of VAT incurred on their gold purchases the cash-flow impact thereof could still be significant. This could potentially distort consumer preferences and undermine the neutrality principle of a VAT system.

Parties to these gold transactions are well advised to review the terms of their agreements as regards pricing and whether it includes or excludes VAT. This will determine which party could ultimately be out of pocket if zero-rating was incorrectly applied.

THIRD JEOPARDY – DOMESTIC REVERSE CHARGE REGULATIONS SOON TO BE INTRODUCED

On 8 June 2022, South Africa's Minister of Finance published regulations (the Regulations) to introduce a domestic reverse charge on "valuable metals", mainly relating to gold-containing material. The Regulations came into operation on 1 July 2022.

The Regulations will apply to the second-hand gold industry and require the purchaser to account for the VAT (at 15%) on the transaction rather than the supplier.

Most importantly, the Regulations do not apply to supplies contemplated in section 11(1)*(f)*. However, in terms of the judgment, second-hand gold does not fall under section 11(1)*(f)* to begin with. This means that as the Regulations have come into effect, banks, the SARB and the SA Mint have to self-account for VAT at 15% on their local purchases of (refined) gold falling within the ambit of the Regulations.

Although the Regulations aim to remove the VAT cash-flow impact of second-hand gold supplies (to the extent that an off-setting input can be claimed by the purchaser), it will result in an unfortunate administrative burden for banks, the SARB and the SA Mint.

CONCLUSION

Whether banks, the SARB or the SA Mint incur VAT at 15% or could be required to self-assess such VAT on gold purchases from second-hand gold sources in future, the VAT cost of (refined) recycled gold just went up.

Gold is an expensive commodity. Any acquisition thereof is intentional and not easily substituted for a different product. The demand for gold by banks, the SARB and the SA Mint will likely not decrease, but they will undoubtedly think twice about the source of the gold they buy and how to be satisfied that the gold could be zero-rated.

"Based on the interpretation of section 11(1)*(f)* as per the judgment, the only time when the origin of the gold can definitively qualify for zero-rating is if the gold is newly mined gold acquired from a mine."

Annelie Giles *(Reviewed by Melanie Harrison)*

ENSafrica

Acts and Bills

- Value-Added Tax Act 89 of 1991: Section 11(1)*(f)*.

Other documents

- Interpretation Note 31 (Issue 4) ("Documentary proof required for the zero-rating of goods or services") (9 March 2016).

Cases

- *Lueven Metals (Pty) Ltd v The Commissioner for the South African Revenue Service* (31356/2021) [2022] ZAGPPHC 325 (19 May 2022).

Tags: zero-rated; VAT exempt/non-taxable purposes.

THE DEDUCTIBILITY OF VAT ON PAYMENTS MADE UNDER LOAN COVER: SCA JUDGMENT IN *CSARS v CAPITEC*

The Supreme Court of Appeal (SCA) handed down judgment on 21 June 2022 in the case of Commissioner for the South African Revenue Service v Capitec Bank Ltd, *[2022].*

The judgment raises questions regarding the interpretation and application of the Value-Added Tax Act, 1991 (the VAT Act), particularly the deduction of value-added tax (VAT) where goods or services are supplied for no consideration.

THE FACTS AND ISSUE IN DISPUTE

Capitec Bank Ltd (Capitec) provides free loan cover to clients with unsecured loans, in the event of the customer's death or retrenchment. Capitec insured its risks in relation to its unsecured loans with third-party insurers. As consideration for the provision of credit, Capitec charged an initiation fee, monthly service fees and interest, all within the maximum limits provided for in the National Credit Act, 2005 (the NCA).

During the VAT period from November 2014 to November 2015, Capitec made payments of R582 383 753.66 in terms of the loan cover provided and made a deduction in terms of section 16(3)*(c)* of the VAT Act of R71 520 811.85, being the tax fraction of the amounts paid under the loan cover.

The South African Revenue Service (SARS) disallowed the deduction and contended that the payments made by Capitec did not qualify for a deduction under section 16(3)*(c)* because the supply of the loan cover did not constitute a "taxable supply" in that (i) the loan cover was provided for no consideration, and (ii) alternatively, the loan cover was provided in respect of an exempt supply.

The matter was first heard by the tax court, where Sievers AJ found in favour of Capitec and held that the loan cover was provided in the course and furtherance of Capitec's taxable enterprise. Regarding SARS' alternative argument, the tax court held that the provision of credit cannot be artificially broken down into the provision of credit on the one side (which is VAT exempt) and a separate transaction in relation to the initiation fee and service fees (which are taxable), and that the loan cover promotes the entire enterprise of Capitec, which includes the making of taxable supplies.

The SCA overturned the judgment of the tax court and held that because the provision of credit is an exempt financial service, the loan cover was supplied in the course of making an exempt supply and no VAT was therefore deductible by Capitec.

THE RELEVANT VAT PRINCIPLES

Section 16(3)*(c)* of the VAT Act provides for a deduction of an amount equal to the tax fraction of any payment made to indemnify another person in terms of any contract of insurance, but only if the contract of insurance is a taxable supply.

A "taxable supply" is defined in section 1(1) to mean any supply of goods or services which is chargeable with tax under the provisions of section 7(1)*(a)*. Section 7(1)*(a)* provides, as far as is relevant, that subject to the exemptions provided for in the VAT Act, VAT is levied on the supply by any vendor of goods or services supplied in the course or furtherance of any enterprise carried on by the vendor.

"Enterprise" is defined in section 1(1) to mean, in the case of any vendor, any enterprise or activity which is carried on continuously or regularly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration. Proviso (v) to the definition of "enterprise" excludes from the definition any activity to the extent to which it involves the making of exempt supplies.

The term "insurance" is defined in section 1(1) to mean insurance or guarantee against loss, damage, injury or risk of any kind whatever, whether pursuant to any contract or law, and "contract of insurance" includes a policy of insurance or an insurance cover but excludes a life insurance policy.

APPLICATION OF THE VAT PRINCIPLES

The VAT system operates on the basis that where a person carries on an enterprise, they must register as a vendor if the value of taxable supplies made in the course of that enterprise during any 12-month period exceeds the VAT registration threshold. Once registered for VAT, the vendor must account for VAT at the relevant rate on all supplies made in the course or furtherance of that enterprise, unless those supplies are specifically exempt from VAT. The VAT must be accounted for on the value of the supply as determined in section 10 of the VAT Act. The vendor may then deduct VAT incurred on goods or services acquired or imported for the purpose of consumption, use or supply in the course of making those taxable supplies. Where the goods or services are acquired partly for making taxable supplies, the VAT may be deducted only to that extent. In addition, a vendor may make the deductions as provided for in section 16(3)*(c)* to (3)*(o)*, where applicable.

Capitec supplies a service comprising of the provision of credit on a continuous and regular basis to its customers for a consideration. The consideration is charged in the form of interest, initiation fees and service fees. Although the provision of credit is exempt from VAT in terms of section 2(1)*(f)*, read with section 12*(a)*, in terms of the proviso to section 2(1) the provision of credit is a taxable supply to the extent that the consideration is any fee.

Capitec therefore carries on an enterprise involving the provision of credit to the extent that it charges fees as a consideration. It is this enterprise which requires Capitec to be registered for VAT, and all supplies made in the course or furtherance of this enterprise are subject to VAT under section 7(1)*(a)*.

The provision of loan cover comprises the "supply" of a "service" and "insurance" within the defined meaning of these terms. Consequently, the provision of the loan cover by Capitec, a registered vendor, not being an exempt supply in terms of section 12, is a "taxable supply" if it is supplied in the course or furtherance of Capitec's enterprise. It should then follow that Capitec qualifies for a deduction for payments made under that insurance in terms of section 16(3)*(c)*. However, if the loan cover is not provided in the course or furtherance of Capitec's taxable enterprise, then no deduction may be made because the loan cover is then not a taxable supply.

DISCUSSION AND ANALYSIS OF THE JUDGMENT

The SCA agreed with counsel acting for Capitec that there is a direct link between the supply of the loan cover and the provision of credit, but stated that it could not be ignored that Capitec is in the business of providing credit and not in the business of providing insurance. This is despite the VAT status of a supply of insurance not being determined by the status of the supplier, but rather by whether the supply is made by a vendor in the course or furtherance of an enterprise, and if it is exempt under section 12. The subject matter of an insurance policy also does not determine its VAT status. The supply of insurance remains taxable even if zero-rated goods (such as fuel) or the loss of money are covered.

The SCA relied on the judgment in *Commissioner for the South African Revenue Service v Tourvest Financial Services (Pty) Ltd,* [2021], where it was held that even if some taxable fees are earned for a financial service, it does not convert what is in the main an exempt supply into a taxable supply. Based on this finding in the *Tourvest case,* the SCA stated that the fact that fees charged by Capitec for its services of providing credit carry VAT, does not mean that the activity of supplying credit loses its exempt nature.

However, in the *Tourvest* case the SCA held (correctly, in our view) that the proviso to section 2(1) creates a mixed supply out of an identified activity, rather than causing the activity to lose its exempt status in its entirety. Accordingly, the activity involving the provision of credit for which fees and interest are charged as considerations comprises a mixed supply. The extent to which credit is provided on a continuous or regular basis for any fee comprises an "enterprise", and if supplied by a registered vendor, the fees are subject to VAT under section 7(1)*(a)*. It is only to the extent that the credit is provided for a consideration other than for a fee (ie, interest), that it is excluded from an enterprise by virtue of proviso (v) to the definition of "enterprise".

"Where the goods or services are acquired partly for making taxable supplies, the VAT may be deducted only to that extent."

The SCA stated that the fees charged for the provision of credit, if not paid immediately, become capitalised and are added to the outstanding loan, which render them exempt. If the debit order is returned unpaid, Capitec automatically extends additional credit to the borrower in the amount of the unpaid instalment, which is a separate supply of credit. The SCA ruled that because the loan cover relates exclusively to this supply of VAT exempt credit, the loan cover is supplied in the course of an exempt supply.

The SCA does not seem to have considered its judgment in *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd (in liquidation),* [1998], where it ruled that the amounts debited to a customer's account do not lose their character. Accordingly, where the outstanding balance on a customer's account is made up of separate debit transactions, each debit entry retains its own identity and origin. In addition, section 126(3) of the NCA requires that payments made by a debtor should firstly be appropriated to unpaid interest charges, secondly to fees or charges, and lastly to the principal debt. This also applies to payments of overdue amounts. For VAT purposes, the provision of credit falls within section 2(1)*(f)* of the VAT Act if money is provided to another person who agrees to pay in the future sums exceeding the money provided. When a debtor defaults, there is no agreement entered into in terms of which the outstanding amount is advanced under a new loan. The amounts outstanding (including the fees) remain payable under the original loan agreement, and each amount outstanding retains its character.

A further question is whether the fact that Capitec provided the loan cover for no consideration resulted in it not being a supply made in the course or furtherance of an enterprise. The activity comprising the provision of credit is, in terms of the *Tourvest* judgment, a mixed supply which comprises an enterprise to the extent that fees are charged. The provision of credit for which interest is charged can therefore not be split from the provision of credit for which fees are charged as consideration. It is one and the same supply, and comprises an enterprise where fees are charged. The question is whether Capitec provided the loan cover in the course or furtherance of this enterprise, albeit for no consideration.

The Australian Tax Office stated that the phrase "in the course or furtherance" is broad enough to cover any supplies made in connection with an enterprise. An act done for the purpose or object of furthering an enterprise, or achieving its goals, is in furtherance of an enterprise. The same interpretation should also find application in a South African context.

The tax court held, based on the evidence, that the loan cover gives Capitec a competitive and marketing advantage to generate fees. The SCA agreed that there is a direct link between the supply of the loan cover and the provision of credit. If the provision of credit for a fee comprises an enterprise, and the loan cover promoted that enterprise, then it should follow that the loan cover was supplied in the course and furtherance of the enterprise, as per the tax court's finding. The supply is then a "taxable supply", subject to tax in terms of section 7(1)*(a)* at the value thereof, which is nil in terms of section 10(23) if supplied for no consideration. However, the SCA held that because the provision of credit is an exempt financial service, the loan cover was supplied exclusively in the course of making an exempt supply and the VAT was therefore not deductible by Capitec.

ADDITIONAL CONSIDERATIONS

The SCA disagreed with counsel for Capitec that VAT apportionment provided for in section 17(1) does not apply to section 16(3)*(c)*, because section 16(3) is made subject to section 17. However, one should appreciate that section 17 only deals with permissible deductions in respect of "input tax" which is a defined term, meaning "VAT charged under section 7 and payable under that section by a supplier of goods or services made to the vendor". A deduction provided for under section 16(3)*(c)* does not comprise "input tax" as defined and is therefore not subject to apportionment under section 17(1). It should then follow that if an indemnity payment is made under a contract of insurance which comprises a taxable supply, the total payment qualifies for a deduction, otherwise no deduction may be made.

The SCA stated that Capitec was allowed an input deduction in respect of the premiums it paid to its insurer and that in terms of section 8(8) it was required to pay output tax on the indemnity payment it received under the insurance policies with its insurer and stated that the deduction made under section 16(3)*(c)* immediately reversed that output tax, which skewed Capitec's books. However, it appears that the insurers were life companies in which case the premiums would not have attracted any VAT. Furthermore, if the loan cover was provided in the course of an exempt supply, as ruled by the SCA, then Capitec should arguably not be liable for output tax on the insurance payments received from its insurers even if the premiums were subject to VAT. This is because section 8(8) only applies to the extent that the payments relate to a loss incurred in the course of carrying on an enterprise, which the SCA held was not the case. Capitec is therefore left in the position that it may have paid VAT on the indemnity payments received from its insurers for which it was not liable and is unlikely to recover the VAT overpaid if the tax periods have prescribed.

IMPLICATIONS OF THE JUDGMENT

The entities that will likely be most impacted by the judgment are financial institutions and providers of loans who also provide loan cover, whether or not for a consideration. They will have to carefully review the VAT status of the loan cover provided and their entitlement to deduct VAT, not only on payments made under the loan cover but also generally on goods and services acquired for their loan businesses, including premiums paid to insurers. These entities should also reconsider the VAT status of indemnity payments received from insurers in relation to their loan business.

Gerhard Badenhorst

Cliffe Dekker Hofmeyr

Acts and Bills

- Value-Added Tax Act 89 of 1991: Sections 1(1) (definitions of "enterprise" (proviso (v)), "insurance", "taxable supply", "supply" & "services"), 2(1)*(f)* (& proviso to section 2(1)), 7(1)*(a),* 8(8), 10, 12*(a),* 16(3)*(c)* to 16(3)*(o)*, 17(1);
- National Credit Act 34 of 2005: Section 126(3).

Cases

- *Commissioner for the South African Revenue Service v Capitec Bank Ltd* (94/2021); [2022] ZASCA 97; 2022 JDR 1744 (SCA);
- *Commissioner for the South African Revenue Service v Tourvest Financial Services (Pty) Ltd* [2021] (5) SA 86 (SCA);
- *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* [1998] 1 All SA 413 (A).

Tags: taxable supply; exempt financial service; loan cover.

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